TSB Banking Group plc

Annual Report and Accounts 2017

"Our performance in 2017 demonstrates that TSB continues to bring more competition to UK banking."

Paul Pester, Chief Executive Officer, TSB

“During 2017, we again demonstrated that a UK bank focused on serving local communities really can thrive.

TSB is growing, our high-tech transformation gathered pace in 2017 and we remain Britain’s most recommended high street bank”

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Summary consolidated balance sheet

	2017 £ million	2016 £ million	Change %
Loans and advances to customers	**30,854.2**	29,419.1	4.9
Other assets	**11,671.3**	7,776.6	50.1
Total assets	**42,525.5**	37,195.7	14.3
Customer deposits	**30,520.6**	29,383.8	3.9
Other liabilities	**10,009.3**	5,946.9	68.3
Shareholder's equity	**1,995.6**	1,865.0	7.0
Total equity and liabilities	**42,525.5**	37,195.7	14.3

Summary consolidated statutory income statement

	2017 £ million	2016 £ million	Change %
Net interest income	**905.3**	853.8	6.0
Other income	**194.5**	146.6	32.7
Total income	**1,099.8**	1,000.4	9.9
Operating expenses	**(859.3)**	(731.1)	17.5
Impairment	**(77.8)**	(87.3)	(10.9)
Statutory profit before taxation	**162.7**	182.0	(10.6)
Taxation	**(44.0)**	(54.2)	(18.8)
Statutory profit for the year	**118.7**	127.8	(7.1)

Segmental analysis of management basis profit before taxation

	2017 £ million	2016 £ million	Change %
Franchise - including Whistletree	**119.7**	131.5	(9.0)
Mortgage Enhancement	**61.7**	46.2	33.5
Management profit before taxation	**181.4**	177.7	2.1
One-off items(1)	**(28.8)**	(30.4)	(5.3)
Banking volatility(2)	**10.1**	2.2	359.1
Gain on sale of share in Visa Europe	**–**	32.5	
Statutory profit before taxation	**162.7**	182.0	(10.6)

Key performance indicators

Operational (explained in the context of our strategy on page 6)			
Customer advocacy – Net Promoter Score (NPS)(3)	**25**	23	2
Share of new personal bank account gross flow(4)	**6.2%**	6.4%	(0.2)pp
Mortgage gross new lending (£ million)	**7,001.5**	6,592.5	6.2%
Financial			
Loan to deposit ratio	**101.1%**	100.1%	1.0pp
Common Equity Tier 1 Capital ratio	**20.0%**	18.4%	1.6pp
Leverage ratio (fully loaded)	**4.5%**	4.8%	(0.3)pp
Group banking net interest margin(5)	**3.02%**	3.09%	(7)bps
Asset quality ratio (AQR)(6)	**0.25%**	0.31%	(6)bps

(1) One off items reflect costs associated with restructuring the branch network and certain migration costs (see page 15).
(2) Banking volatility reflects gains and losses on derivatives not in hedge accounting relationships, hedge accounting ineffectiveness, and volatility associated with share schemes.
(3) NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who give a score of 9 or 10 after subtracting the percentage who give a score 0 to 6. Calculated as a 12 month rolling average.
(4) Source: CACI Current and Savings Account Market Database (CSDB) which includes current, packaged, youth, student and basic bank accounts, and new account openings excluding account upgrades. Data presented on a 2 month lag.
(5) Management basis net interest income divided by average loans and advances to customers, gross of impairment allowance (see page 21).
(6) Impairment charge on loans and advances to customers divided by average loans and advances to customers, gross of impairment allowance.

Chief Executive Officer's statement

During 2017 TSB continued to deliver on its mission to bring more competition to UK banking. It's now four years since we launched and we continue to demonstrate that a bank focused on serving local communities really can thrive. The Bank is growing, and our high-tech transformation has gathered pace in 2017. We exceeded our target of attracting more than 6% of all new and switching bank accounts in the UK for the fourth year in a row, our lending has grown by more than 50% since launch to over £30 billion, we continue to be Britain's most recommended high street bank, and we delivered a statutory profit before tax of £162.7 million.

Our growth strategy

TSB's three strategic pillars have remained the same since relaunching onto high streets across Britain in September 2013:

- to provide the kind of banking experience that people tell us they want and we believe they deserve;
- to provide great banking to more people; and
- to help more people to borrow well.

We made significant progress through the year on all three as summarised below and explained further in the context of Board approved key performance indicators on page 6.

Providing the kind of banking experience people want and deserve

In 2017 we continued to invest in becoming a more agile, digital business. Our high-tech transformation has continued at pace, and we will be the first major bank in the UK to have designed and built a state-of-the-art banking platform for the digital age. The new platform is already being used to support a number of our core services, and customers are experiencing the benefits. In April, we launched our new mobile app, and have continued to develop and enhance it every month since, responding directly to customer feedback. TSB customers were also the first in Europe to use iris scanning security with our mobile app and among the first in the world to use Apple's new facial recognition technology, accessing their accounts simply by glancing at their phones.

In November we unveiled our new banking platform to journalists, analysts and TSB Partners. TSB Partners are now using the platform for bank account services, and mortgage brokers are using it to help customers access new TSB mortgages. The final phase of the IT Migration Programme (the Programme) and the platform's roll-out to customers will follow in 2018. Alongside this, we also continue to invest in our people, and in our branch network to provide our customers with excellent levels of service however and wherever they choose to bank with us. In August, we started work on our third purpose-built, flagship branch in Manchester, which will open in 2018.

TSB continues to build a different sort of bank with a diverse, inclusive and transparent culture. TSB has been tackling gender imbalance and we were proud to be one of the first companies to sign up to the Women in Finance charter and to publish our gender pay gap data. We seek to create a sustainable gender balanced workplace at TSB that reflects the communities we serve.

The results of these efforts continue to be recognised. In 2017, TSB was identified as one of the top 10 big companies to work for in the UK, the only bank on the list, and was recognised as a Great Place to Work. Customers continue to recommend TSB to friends and family and we are Britain's most recommended high street bank. While we are proud of our continued progress in 2017, there is always more to be achieved in realising our potential to provide the kind of banking experience people want and we believe they deserve.

Providing great banking to more people

When we launched we set out to grow our market share of bank accounts by consistently attracting more than 6% of all new and switching bank accounts over a five year period. In 2017 we exceeded our target with 6.2% of all customers switching banks or opening a new account choosing TSB, equivalent to around 1,000 customers a day. However, the number of people switching their bank account provider in the UK is falling. TSB believes that the industry needs to do much more to bring real competition to UK banking and we continue to campaign for a standard format monthly bill for all bank account customers, a switching service that works for everyone, including overdraft users, and for banks to make their customers aware of their ability to switch.

Helping more people to borrow well with TSB

In 2017 customer lending grew by 4.9% to over £30 billion; this has now grown by over 50% since launch. Growth in customer lending was supported by our mortgage offering with Franchise mortgage balances increasing by 15.1% to £26 billion. TSB's award winning mortgage broker service delivered a 5 star service for the third year running which contributed to TSB providing £7 billion of new mortgage lending to help more than 47,000 homeowners to get a better mortgage deal or buy a new home through the year. We have continued to grow TSB in a responsible way, with our ambition to help more people borrow well evidenced by the average mortgage loan to value which remains low at 44.2%.

Chief Executive Officer's statement (continued)

Our growth strategy (continued)

Helping more people to borrow well with TSB (continued)

Following on from developments in 2016, TSB's personal unsecured loans were made available through our branch network and digital channels during 2017 to customers who do not yet have a TSB bank account. This supported the growth of 16.9% in personal unsecured loans balances. In order to ensure that all consumers are able to borrow well TSB believes that the personal loans industry needs to be exposed to the full force of competition – and in April we launched our *Consumers Matter: Loans* campaign to create a market where consumers know what they are getting, can shop around freely and are able to switch.

In November, the Bank of England increased the base rate by 0.25% to 0.50%, unwinding the rate cut it made in August 2016. As a result, we put our customers' variable rate mortgages and savings back to the position they were at before the Bank of England reduced rates. With this being the first base rate increase in over a decade, we knew that our customers would have many questions about how the increase would affect them, and TSB Partners in our branches and on our customer service team were on hand to help guide customers through this change.

Financial summary

Customer advocacy and trust in TSB has translated into strong balance sheet growth. During 2017 customer deposit balances increased by £1.1 billion (3.9%) to £30.5 billion. This provided funding to support the third pillar of TSB's strategy, to help more customers to borrow well, with total loan balances increasing by £1.4 billion (4.9%) to £30.9 billion. This was driven by a £3.7 billion increase in Franchise loan balances partially offset by the early return to Lloyds Banking Group (LBG) of the £1.7 billion Mortgage Enhancement portfolio in June 2017 and the expected reduction in the Whistletree portfolio, purchased in 2015.

On a statutory basis, profit before taxation was £162.7 million, down £19.3 million (10.6%) compared with 2016. This was largely driven by the previously reported and expected increase of £122.0 million in outsourcing fees paid to LBG in 2017, and the recognition in 2016 of a £32.5 million non-recurring gain on the sale of our share in Visa Europe following its acquisition by Visa Inc.

These anticipated reductions in profit were largely mitigated by a £96.0 million increase in net interest income from the Franchise business, reflecting the continued success of our strategy, and an increase in profits from the Mortgage Enhancement portfolio of £15.5 million. Profits from this portfolio increased to £61.7 million in 2017 (compared with £46.2 million in 2016) and included a £49.7 million gain on its divestment which had the effect of accelerating future profits to the first half of 2017.

On a management basis, which excludes certain items of a one-off nature such as the gain on the disposal of shares in Visa Europe in 2016, profit before taxation increased by 2.1% to £181.4 million. This is the basis of presentation used by management to assess the underlying performance of the business.

Outlook – delivering through uncertainty

TSB remains one of the most strongly capitalised banks in the UK and, with a healthy liquidity reserve, is well positioned to weather economic uncertainty or shocks. Most commentators predict that economic and market conditions are likely to remain uncertain for a range of reasons, including the UK's exit from the EU. While we continue to be confident in the strength of the UK economy, we are mindful of the challenges ahead.

As previously announced, we re-planned the final phase of the roll-out of our new banking platform to customers into 2018. Until this final phase of the migration is completed, and as we have seen this year, the contractual increase in outsourcing fees paid to LBG will continue into 2018. We also note that interest rates are predicted to remain at historically low levels, placing pressure on net interest margins for all banks. The effect of these factors, together with the continued roll-off of the Whistletree portfolio and the early return of the Mortgage Enhancement portfolio will, we expect, lead to a reduction in our statutory profit before tax in 2018. However, excluding the effects of the increased outsourcing fees, we expect 2018 management profit from TSB's Franchise business to continue to grow.

Looking forward, when the roll out of the new platform is complete, TSB's costs will reduce considerably as the increase we have seen in LBG outsourcing costs is reversed. TSB's new state-of-the-art banking platform will enable us to make banking even better for UK consumers and, importantly, small businesses and entrepreneurs. Customers are already seeing the benefits of the new platform, and it will enable us to be more agile in responding to customers' needs as they evolve. This Migration Programme is, of course, of such scale and strategic importance that it does not come without delivery and operational risks. The management of these risks is overseen by the Audit Committee on behalf of the Board as described on page 10.

Chief Executive Officer's statement (continued)

Helping local communities to thrive

Our Partners in branches and offices continued to work with a good cause or charity in their local community and, since the launch of our new communities strategy in February 2015, £2.3 million has been donated to over 1,200 local causes. In addition to these fundraising activities, more than 1,800 TSB Partners have spent time supporting a local good cause in their community when they would normally be working. Also, in 2017 TSB has continued to demonstrate its commitment to help local communities by partnering with Trinity Mirror for Pride of Britain and Pride of Sport. These awards celebrate ordinary people who do extraordinary things for the benefit of their local communities.

Bringing more competition to UK banking

Our mission to bring more competition to UK banking and ultimately make banking better for all UK consumers remains unchanged. TSB has set out three principles to help consumers get a better deal and make markets fit for competition. We continue to call for an environment where: consumers know what they are getting; consumers can shop around freely; and consumers can vote with their feet and move easily. We continue to urge the competition authorities, policy makers and regulators to do their bit to bring the full force of competition to bear on the market.

Since launch we have been focused on breaking the stranglehold that the big five banks have on the retail banking market. In 2018, our new platform will unlock the opportunity for us to broaden this focus by providing the capability to help more local businesses to thrive right across the UK – and bring much needed competition to the small business banking market.

We are supportive of any initiatives that bring more competition to UK banking, and we are well positioned to compete for one of the grants from the Capability and Innovation Fund recently announced by the UK Government and designed to boost competition in the business banking market. We will be submitting a bid for a Pool A grant in 2018, and we can't think of anyone else better placed than TSB to make use of the Fund in bringing more competition to small business banking.

Board Chairman

Towards the end of 2017, our Chairman, Will Samuel, indicated his intention to step down as a Director and Chairman of TSB Group following the approval of this annual report. Richard Meddings, who joined the Board during 2017, will succeed Will as our new Chairman. I'd like to take this opportunity to thank Will personally, and on behalf of the Board, for his service and support as Chairman over the past four years. It's been an extraordinary few years for TSB – from launching the bank back onto high streets and listing on the London Stock Exchange, to becoming part of the Sabadell Group and moving to our new, state-of-the-art, banking platform. Richard brings a wealth of experience and a deep understanding of UK retail banking both from a consumer and business perspective, and I look forward to working together with him as TSB continues to bring more competition to UK banking and ultimately make banking better for all UK consumers.

Conclusion

Our performance in 2017 demonstrates that TSB continues to deliver on its mission of bringing more competition to UK banking. At the heart of that strategy is our unrelenting focus on our customers, and the commitment and energy that our Partners bring to serving our customers every day. Without their passion and dedication TSB would not be where it is today, and I thank all our Partners for their hard work.

Looking forward, TSB is well placed to continue to thrive despite a potentially uncertain economic environment. Our ability to bring more competition to UK banking, including small business banking, will be enhanced by the delivery of our new IT platform. We remain confident that TSB is an attractive long-term home for customers – and one that is increasingly distinct from other banks on the high street.

Paul Pester
Chief Executive Officer

Our strategy and key performance indicators

Strategic priority	2017 performance	Key performance indicator

Provide the kind of banking experience people want and deserve

Strategic priority

Build greater consideration of the TSB brand.

Deploy TSB's strong digital capability.

Deliver a differentiated customer experience through our Partners.

2017 performance

Building the TSB Brand

- TSB continued to be Britain's most recommended high street bank for 2017, as measured by independent research company BDRC.
- TSB continued to partner with Trinity Mirror for Pride of Britain and Pride of Sport in 2017 reinforcing TSB's commitment to local communities.
- TSB was identified as one of the top 10 big companies to work for in the UK, and was recognised as a Great Place to Work. (Further information on how our Partners support the values that underpin the TSB Brand is set out in our Partners' report on page 43).

Strong Digital Capability

- TSB continued to invest in becoming a more agile, digital business.
- A key strategic priority to further support TSB's ability to make banking better for all UK consumers is our continued investment in migrating our banking platform from the one provided by LBG to a new, state-of-the-art platform designed and built with Sabadell.
- Customers are starting to see the benefits through our new TSB banking app and during 2017, TSB customers became the first in Europe to use iris scanning security with their mobile banking app, logging into their TSB accounts just by looking at their phones. They were also amongst the first to use Apple's new facial recognition technology to log in to their TSB account
- Going forward, the new platform will enable TSB to be more agile in responding to customers' needs as they evolve.

Customer Experience

- Customers continue to recommend TSB to friends and family with the Bank's Net Promoter Score remaining strong, increasing by a further 2 points in 2017.

Key performance indicator

Customer advocacy (Net Promoter Score)(1)

2017	2016
25	23

Provide great banking to more people

Strategic priority

Grow market share of bank accounts by consistently taking a greater than 6% share of gross flow over a five year period.

2017 performance

- TSB continued to exceed its 6% flow target, with 6.2% of all customers switching or opening a new account choosing TSB during 2017.
- In addition to the strong performance of the Classic Plus account, more customers are choosing TSB for their savings. During 2017, deposits grew by 3.9% to £30.5 billion reflecting customers' continued trust in TSB.

Key performance indicator

Share of personal bank account gross flow (%)(2)

2017	2016
6.2%	6.4%

Share of PCA stock (%)

2017	2016
4.6%	4.5%

Help more people borrow well

Strategic priority

Grow Franchise customer lending by 40% to 50% over a five year period from IPO.

2017 performance

- Balance sheet growth continues to remain strong with total customer lending balances up 4.9% to £30.9 billion in the year, exceeding the target to grow customer balances by 40-50% within 5 years of the IPO.
- Mortgage gross lending continues to increase. The mortgage intermediary channel, launched in January 2015, continues to perform well and has seen £5.4 billion of mortgage loan completions advanced through this channel in 2017.

Key performance indicator

Mortgages gross new lending (£m)

2017	2016
7,001.5	6,592.5

Unsecured asset growth (£m)

2017	2016
232.9	36.0

(1) NPS is based on the question "On a scale of 0 to10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who give a score of 9 or 10 after subtracting the percentage who give a score of 0 to 6. Calculated as a 12 month rolling average.

(2) Source: CACI Current and Savings Account Market Database (CSDB) which includes current, packaged, youth, student and basic bank accounts, and new account openings excluding account upgrades. Data presented on a 2 month lag.

How we make money – our business model

A transparent and straightforward local banking business model

At TSB we believe that bringing more competition to UK banking will ultimately make banking better for all UK consumers. We are doing this by building the sort of bank that customers have told us they want: a transparent and straightforward bank that supports local economic growth and helps local people help themselves. We call this 'Local Banking for Britain'.

Banking is based on the effective evaluation of risks, ensuring an appropriate return is earned for taking them. The overall level of risk we are willing to take, our 'risk appetite', is determined by our Board, and robust systems and practices are in place to support TSB Group operating in line with these predetermined parameters. This helps protect both our customers' and the shareholder's interests.

Our business model is simple

TSB's business model reflects a straightforward and simple retail business and is outlined below:

Components of our Business model	Description	Further information	Financial statements
Banking experience	We seek to deliver a banking experience that is the primary reason for customers to choose and remain with us, and increasingly sets TSB apart from other banks and providers of financial services. Central to our banking experience is the development of our brand, investments in our branch, telephony and digital capabilities and customer led service ethos. Our brand is based on transparent and straightforward values which underpinned TSB when it was established more than 200 years ago for the purpose of helping local people, and the communities they lived in, to thrive together. These values remain as relevant today as they did then.	Page 3	n/a
Sources of funding	Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets and equity invested by the shareholder.	Page 16	Page 68
Loans	Funds deposited with TSB are used to support lending to customers who wish to borrow. A portion of funds are held in reserve, in the form of a liquidity portfolio, to meet any unexpected funding requirements.	Page 19	Page 72
Income	We earn income in the form of interest that we receive on the loans we make to customers and we pay interest to savings and bank account customers on the money they deposit with us. We also earn other income in the form of fees and charges for the provision of other banking services and commissions from the sale of certain products such as general insurance.	Page 21	Page 82
Charges	Running a bank with over 5 million customers comes with overheads. Charges we incur include the costs of paying our 8,500 TSB Partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the bank in the form of an impairment charge. Finally, TSB Group pays tax to Her Majesty's Revenue and Customs (HMRC).	Page 22	Page 84
Profits and returns to the shareholder	The Board reviews TSB Group's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB Group faces, or returned to the shareholder in the form of dividends. Currently, all returns are being reinvested in the business.	Page 23	Page 89

Non financial disclosures

Being responsible is a core value at TSB. The Group is mindful of the impact that its actions can have on customers and local communities across Britain as well as on its Partners. We outline the importance of the role that our Partners play and our commitment to our wider social responsibilities in delivering our customer centric strategy in the Chief Executive Officer's statement on pages 3 to 5 and in the Partners' report on pages 43 to 45. We are also committed to reducing our environmental impact and using resources in a more responsible way as outlined in the Directors' report on page 42. Financial crime (including bribery and corruption) is one of the principal risks that we face as a bank and pages 10 and 11 of the Risk management section describe the steps we take to mitigate this risk.

Risk Management in TSB

Approach to Risk

TSB Group identifies, assesses and manages the risks inherent in its business model and strategy, seeking to ensure that TSB Group remains financially liquid, solvent, operationally stable and trusted. Risks faced by TSB Group in delivering its business strategy are managed to protect the interests of customers, Partners, and our shareholder. Our approach to managing these risks is described in our overarching Risk Management Framework.

Risk Management Framework

The Risk Management Framework provides the foundation for all of the risk management activities and processes in TSB Group. The framework is designed around a simple model for categorising risk, so that all the components of our risk management such as, risk appetite, governance, policies, reporting and assurance and organisational design are aligned to the same hierarchy of risks. At the top of this hierarchy are four principal risks faced by TSB Group.

Principal risk categories

Financial Risk	The risk of the firm having inadequate earnings, cash flow or capital to meet current or future requirements and expectations as they fall due.
Credit Risk	The risk that a genuine or fraudulent borrower or counterparty fails to pay the interest or to repay the principal on a loan or other financial instrument as they fall due.
Operational Risk	The risk of loss, damage or disruption arising from inadequate or failed processes, people and systems.
Conduct Risk	The risk to the delivery of fair customer outcomes and market integrity.

Accountability

Risk management is embedded at all levels of TSB Group through clear accountabilities across three independent lines of defence. This enables clear understanding and ensures separation between functions that own and manage risks faced by the business (first line), provides oversight and challenge (second line), and provides for independent audit and assurance (third line).

The three lines of defence

First line of defence	As the first line of defence, all business units and line management have ownership and primary accountability for directly assessing, controlling and mitigating risks within their area of responsibility. The first line of defence establishes controls to ensure compliance with TSB Group's policies, risk appetite and regulatory requirements. Specialist Risk functions in the first line provide subject matter expertise for one or more risk category (e.g. Credit). Business Unit Control functions support the business to manage their risk profile and provide evidence through risk reporting and control testing.
Second line of defence	The second line of defence sits within TSB Group's Risk Division. The second line sets enterprise wide standards for risk management activity and provides independent assurance that the first line is managing risks to these standards. The second line Risk Oversight teams monitor and oversee risk management activity in the first line and aggregates risk reporting to maintain an enterprise wide view of TSB Group's risk profile and risk appetite.
Third line of defence	TSB Group's Internal Audit function forms the third line of defence and provides independent and objective assessment of the risk management activities of both the first and second lines. Internal Audit reports on the effectiveness of TSB Group's risk management activities to the Board and senior management.

Partners in TSB Group are individually accountable for identifying, assessing and managing risks within their area of responsibility. Risk management responsibilities are embedded through a risk focused culture, supported by efficient governance and achieved through a prudent risk appetite to support TSB Group's growth strategy.

Risk Culture

Partners' accountability for risk management is reflected in TSB Group's risk culture which stems from its core values to be pioneering, responsible, straightforward, collaborative and transparent. TSB Group aims to have a strong conduct and customer focused culture that maintains regulatory standards. TSB Group is a responsible lender and aims not to lend more than its customers can afford. Partners in TSB Group are guided through training on how to meet customers' needs and treat them fairly. A suite of policies and risk appetite measures support Partners to keep TSB Group within its risk appetite. The importance of individual accountability for managing risk is reinforced by both TSB Board and TSB Group's approach to performance management and remuneration for all Partners.

Risk Management in TSB (continued)

Risk Governance

The culture of risk awareness and behaviours that support the achievement of sustainable business goals and the right customer outcomes are underpinned by TSB Group's governance model. A committee structure enables fast, efficient decision making with an appropriate minimum of bureaucracy, providing clear escalation and reporting of risk to senior management and the Board.

Each committee within the governance structure is responsible for ensuring that a risk and control environment is established within its area of authority. Clear reporting lines are established through the Bank Executive Committee and the Board Risk Committee, and ultimately to the Board which is responsible for providing oversight of the effectiveness of the risk management framework. Further information on TSB Group's committee governance is set out in the corporate governance statement on pages 25 to 32.

TSB Group's risk committees are aligned to the four principal types of risk. Collectively, the Executive risk committees monitor and challenge risk exposures and take appropriate action to monitor TSB Group's risk profile across each principal risk type in line with the risk appetite set by the Board.

Risk Appetite

TSB Group defines risk appetite as the amount and type of risk that it is willing to take in the pursuit of its objectives. The Board approves the risk appetite within each planning cycle, and, through a hierarchy of regular reporting, monitors performance against appetite, seeking to ensure that senior management operates within appetite and, if necessary, has appropriate plans to address any appetite breaches. TSB Group aligns its risk appetite to its strategy through a statement of its attitude to each of its four principal types of risk. These, along with appetite measures and thresholds, are articulated in the Risk Appetite Statement.

Attitude to risk statements

Financial Risk	• We use our capital effectively and efficiently to fuel TSB's growth, whilst ensuring that we remain solvent in all plausible scenarios. • We ensure that we maintain an underlying risk-adjusted margin which is sufficient to cover our operating costs, and to deliver an appropriate return to our shareholder. • We maintain a prudent liquidity profile to ensure that we can continue to operate under stressed conditions, and will limit the proportion of our balance sheet which is reliant on wholesale funding. • We provide products, such as fixed rate loans and deposits, which allow our customers to limit their exposure to interest rate fluctuations. In turn, through hedging activity, we manage TSB's market risk position to ensure that we do not suffer significant loss in the event interest rates fluctuate.
Credit Risk	• We are a responsible lender and aim not to lend more than we or our customers can afford. • We design our lending to be sustainable and profitable under stress. • We have an appetite to grow in the retail and SME lending markets and to make efficient use of our platforms and distribution capabilities. • We maintain a well-balanced and capital efficient portfolio that is focused on UK customers and assets and prime lending criteria. • We do not allow any high risk concentration to develop that might threaten our financial stability or allow TSB to become an outlier compared to peers.
Operational Risk	• In order to deliver our objectives, we need to take risks, and may suffer events and losses whilst doing this. However we are only prepared to accept a low number of events and losses caused by TSB or its suppliers which materially detriment our customers, Partners, reputation or financial performance and we have no appetite to damage our relationship with our regulators. • Our customers expect that they can bank with us '24x7', and as a result we have a limited appetite for interruptions to service to prevent them from doing so. • Our customers expect that their personal data is safe with us. We aim never to put their details at risk.
Conduct Risk	• We aim to have a strong conduct and customer focused culture. Our system of governance, reporting and controls support fair customer outcomes and Partner reward, do not undermine market integrity and maintain regulatory standards. • We understand people make mistakes. But, we will not tolerate systemic conduct failings in any area. • Our product design, sales practices and post sales servicing aim to ensure that products and services are straightforward, transparent and meet customer needs and expectations and deliver a fair exchange of value.

Risk Management in TSB (continued)

Principal risks and uncertainties

Banking is based on the effective evaluation of risks. Processes to identify, measure and control risk are fully embedded in TSB Group's risk management framework. The IT Migration Programme to move TSB Group's IT and operational services from LBG to a new IT platform provided by Sabadell is a key strategic imperative which should enable TSB Group to become more innovative and agile in delivering its banking experience and reduce operating costs considerably. Given the size and scale of this programme, it is considered the most significant cause of risk to the delivery of TSB Group's strategy.

Migration risk

TSB Group is currently undertaking an extensive Migration Programme which could have impacts across a number of areas of our business, including operational stability, service resilience, vulnerability to financial crime, regulatory compliance, and data security and could, therefore, impact the quality of experience that TSB Group provides to its customers. Migration also presents a risk that management focus is diverted from day to day activities and other strategic initiatives to the delivery of the Migration Programme. TSB Group mitigates these risks by:

- Managing the migration through a Board-led enterprise wide change programme, with an effective TSB Group wide governance structure, including Audit Committee oversight and challenge of the management of the Programme's risks (as reported in the Audit Committee report starting on page 35).
- Close management by the business of the programme risks throughout the migration lifecycle, including additional governance specifically created to support migration delivery activities, and regular review of the associated controls.
- Independent monitoring, assessment and oversight of the risks and controls by second line (Risk) and Internal Audit covering both programme delivery and business as usual activities.
- Using the significant experience of Partners in TSB Group and Sabadell who have successfully delivered large scale change and migration projects, specifically using their knowledge of the risks that arise in such projects.

Principal risks arising from TSB's business model and strategy

Providing the kind of banking experience people want and deserve

<table>
<tr><td colspan="2">Conduct risk
TSB seeks to provide a first class banking experience that meets the needs of its customers by getting the basics of banking service right whilst delivering compelling value propositions for customers that set it apart from the competition. TSB Group aims to have a strong and customer focused culture, which maintains market integrity and regulatory standards. The principal conduct risks to delivering fair customer outcomes are described below along with the steps that TSB Group takes to mitigate the impact of the risks.</td></tr>
<tr><td>Principal conduct risks to delivering fair customer outcomes</td><td>• Product design: the risk that product design gives rise to poor customer outcomes, compromises market integrity or breaches regulation.
• Product sales and promotion: the risk that the selling and promotion of its products gives risk to poor customer outcomes, compromises market integrity or breaches regulation.
• Product servicing: the risk that on-going customer service gives risk to poor customer outcomes. This risk is increased where a customer's individual circumstances or potential vulnerability are not appropriately considered.
• Financial crime: The risk that systems and controls are not adequate to manage criminal conduct within TSB's risk appetite and regulatory framework. Includes the risk of bribery and corruption.
• Firm and governance risk: The risk that weaknesses in TSB Group's overarching systems of governance, reporting and control impact on customer outcomes, market integrity or regulatory compliance.</td></tr>
<tr><td>How TSB Group manages its conduct risks</td><td>The management of a suite of Board approved conduct risk appetite measures seeks to ensure that all elements of conduct risk operate within appetite. Product design, services and channels are monitored and managed to provide value over time, meet our customer requirements and deliver fair outcomes for customers. Regular outcome testing takes place to ensure that customers are receiving a fair outcome from any interaction with TSB Group.

A suite of policies and procedures are maintained which seek to ensure consistent standards of customer treatment. Potentially vulnerable customers are identified at an early stage and are provided with appropriate assistance to ensure their personal circumstances are considered throughout their relationship with TSB Group.

All TSB Group's Partners have regulatory responsibilities and personal obligations to deter, detect and disrupt those who would seek to use TSB to facilitate any form of financial crime including bribery, corruption and money laundering. Partners regularly undertake an education and awareness programme with the aim of ensuring roles and responsibilities are understood.

The risks inherent to TSB Group's business model give rise to exposures to bribery and corruption primarily through the branch network, intermediaries and third party suppliers. The anti-bribery policy and underlying standards provides controls and guidance to manage these risks. The policy applies to all TSB Group Partners and third parties who conduct business on behalf of TSB Group.

Compliance with regulation and legislation is maintained through a regular review of changes which seeks to ensure a timely response. The effectiveness of controls and governance is regularly monitored and assessed.</td></tr>
</table>

Risk Management in TSB (continued)

Operational risk	
The banking service provided by TSB Group through its day to day business creates operational risk that could result in loss, damage or disruption. TSB Group manages these risks through its comprehensive risk management framework. The principal operational risks are described below along with the steps that TSB Group takes to mitigate the impact of the risks	
Principal operational risks arising from delivering the TSB Group banking service	• **Service resilience:** The risk of interruption to significant functions and services due to inadequate capacity management, recovery strategies or continuity of systems, processes and controls. • **Cyber/information security:** The risk associated with acquiring, retaining, using and destroying physical and electronic data. This includes maintaining the integrity and appropriate use of data, particularly customer data (privacy) as well as the confidentiality, availability and protection of data from both internal and external cyber-attack (security). Potential impacts could include IT service availability, internal/external fraud, and/or customer data loss. • **Sourcing and contracting:** The risks arising from supplier selection, the establishment of effective service agreements, and the ongoing management of material suppliers. • **Fraud**: The risk of exposure to losses arising from criminal activity perpetrated to achieve financial gain at the expense of the firm and resulting in customer detriment or reputational damage.
How TSB Group manages its operational risks	TSB Group operates an effective operational risk policy and framework to identify and assess its operational risks, understand their potential impacts, and take action to mitigate and control them. To maintain its service, incident management systems and processes are in place to identify and respond quickly to customer issues arising from these risks in order to lessen their impact. TSB Group has defined and implemented effective governance, reporting, and controls with LBG and SABIS (its key IT providers) to manage risk and service issues, and aims to ensure an effective, stable and compliant service. The external criminal environment is continually evolving with new threats and attacks identified almost daily. TSB Group is committed to making customers' banking experience as safe as possible. Through the effective management of its Security Operations Centre (SOC) the Chief Information Security Officer (CISO) monitors the cyber threat and works with other firms, enforcement agencies, and government/industry experts to make the best use of intelligence and technology to identify and prevent suspicious activity. To successfully manage its third party deliverables TSB Group operates a sourcing and contracting framework to complete due diligence, aiming to ensure contractual terms are appropriate, and operates a supplier management framework to monitor and manage the ongoing relationship. TSB Group is, on occasion, targeted by criminals attempting to defraud the business and/or customers. Systems pro-actively monitor and protect against suspicious activity. TSB Group operates an online Fraud Prevention Centre to educate its customers about the potential risks and ways in which it can work with customers to prevent fraudulent activity. In the event of fraud occurring, TSB Group works with all parties with the aim of ensuring that a fair customer outcome is achieved.

Risk Management in TSB (continued)

Provide great banking to more people

Financial risk TSB Group's banking model is based on customer deposits as its primary source of funding to support lending activities and help more people to borrow well. Some of the principal financial risks from TSB Group's banking model are detailed below along with the steps it takes to mitigate the impact of the risks.	
Financial risks arising from TSB Group's growth strategy	• **Capital Adequacy:** The risk associated with the failure to retain sufficient reserves or quality of capital to cover TSB Group's statutory requirements, losses, and support business strategy. • **Liquidity:** The risk that the TSB Group is unable to meet its liabilities as they fall due, or is unable to maintain regulator, investor, customer or other stakeholder confidence that this will be achieved. • **Profit resilience:** The risk that the firm fails to realise planned profits by a significant margin, or that profits are the subject of excessive levels of volatility. • **Interest rate:** The risk that the net value of, or net income arising from, the firm's assets and liabilities is impacted as a result of changes to interest rates.
How TSB Group manages its financial risks	Regular stress testing, including the Internal Capital Adequacy Assessment Process (ICAAP) assessment of the adequacy of TSB Group's capital, and regulatory change impact assessments, seeks to ensure that TSB Group maintains sufficient capital for continuing growth. TSB Group maintains a stable and diverse funding profile. It undertakes an Internal Liquidity Adequacy Assessment Process (ILAAP) assessment of the adequacy of liquidity and funding resources, retains sufficient liquidity to meet its financial obligations as they fall due and uses wholesale funding facilities, including the Bank of England's Term Funding Scheme (TFS) where considered appropriate. Profit resilience is maintained through continued strong growth, whilst also reducing operating costs through the successful delivery of IT Migration. TSB Group also benefits from protection from certain historical conduct matters under an indemnity arrangement with LBG established at the time of TSB Group's initial public offering. Despite the recent rise in base rate, rates remain historically low resulting in continued margin pressures. TSB Group uses derivative financial instruments in the normal course of business to manage interest rate risk. The hedge effectiveness of these derivatives is monitored regularly.

Helping more people borrow well with TSB

Credit risk The key credit risks faced by TSB Group in helping its customers to borrow well are that a genuine or fraudulent borrower fails to pay the interest or principal as it falls due. Some of the principal credit risks are detailed below along with the steps TSB Group takes to mitigate the impact of the risks.	
Credit risks arising from TSB Group's responsible lending strategy	• **Retail credit**: The risk that borrowers fail to repay on time interest or principal arising from personal or non-personal lending, and the risk of credit application fraud. • **Wholesale credit:** The risk of credit losses arising from counterparty lending, or the wholesale funding market. This includes credit losses from wholesale financial instruments including swaps, hedges, securitised bonds and government funding initiatives. • **Credit models:** The risk that models used to manage credit risk are inadequate, are used inappropriately, or perform ineffectively.
How TSB Group manages its credit risks throughout the credit lifecycle	TSB Group adopts decision making processes and systems geared to provide affordable lending. The assessment of a customer's creditworthiness is based on individual needs and circumstances at the time of application. This approach helps customers borrow well and limits the risks associated with non-repayment. Credit risk appetite is set for responsible and controlled growth and has measures and limits in place to act as a mechanism to prevent the bank and its customers from overreaching their ability to manage their borrowing. These measures include loan-to-value thresholds, loan-to-income ratios and credit concentration limits. Occasionally, customer circumstance can change which could impact their ability to repay borrowings. TSB Group understands this and works with its customers to improve their position by offering various treatment strategies and support. TSB Group manages its exposure to wholesale credit risk carefully, applying strict external counterparty credit quality thresholds including monitoring the rating of counterparties. All credit models utilised by TSB Group are subject to regular independent assessment and validation. This is with the aim of ensuring that models are operating as designed and provide the correct outcomes. Any unexpected outcomes are rectified before the model becomes part of TSB Group's credit risk management strategy.

Risk Management in TSB (continued)

Emerging risks

TSB Group's inherent risks are managed effectively through its risk management framework. TSB Group also monitors emerging and evolving risks that could increase in significance and may have an impact on TSB Group's strategy or pose a threat to its business model.

Some of the key emerging risks and uncertainties in TSB Group's operating environment are described below. TSB Group regularly considers the likelihood of the relevant risk materialising and the potential impact on its business strategy, customers, Partners and shareholder. TSB Group uses this assessment as part of the business planning process.

Global economic and political trends	TSB Group is exposed to inherent risks from the macroeconomic environment. Political uncertainty leading to adverse economic changes could have an impact on its business, customers and shareholder. Developments regarding the UK's withdrawal from the European Union are monitored and potential impacts have been included in TSB Group's business planning and stress test scenarios.
FinTech and digital competition	TSB Group operates in a challenging UK retail banking market and is fully aware of the competition it faces from other banks, large and small, and other financial services models such as peer-to-peer lending. The development of open banking platforms in response to the Payment Services Directive 2 (PSD2) ahead of the finalisation of the regulatory technical standards demonstrates how FinTech and other technological advances create a threat to the traditional value chain and ways in which all banks currently operate and service customers. These risks are considered as part of the business planning cycle where TSB Group explores how it can continue to bring more competition to UK banking as technology and traditional value chains evolve and customer needs change. One of the major benefits of moving to the agile operating system offered by Sabadell will be TSB Group's ability to react and to lead in market developments. In due course, this will allow TSB Group to design, develop and deploy new products and services at a greater pace than it is currently able to.
Regulatory change	Due to the nature of the financial services industry, TSB Group faces a complex legal and regulatory environment. Inadequate or incomplete adoption of regulatory initiatives could lead to increased costs, loss of competitive edge or regulatory sanction. TSB Group monitors forthcoming legal and regulatory changes and continues to invest in its people and IT systems with the aim that standards are met and maintained. All legal and regulatory changes faced by TSB Group are managed through an effective governance and oversight framework. The protection of customer data and compliance with the data protection regulations are at the forefront of TSB Group's strategy. The need to ensure compliance with the incoming General Data Protection Regulation (GDPR) from May 2018 has provided the opportunity to review current processes and develop solutions which includes enabling customers to have more options and control over how their data is used and protected. During 2017, TSB Group completed work to understand the potential impact of IFRS 9 on our business model and continues to monitor emerging practice and developments at an industry level. The developments from Basel IV are also being monitored, but are not currently expected to be material. New requirements under the Markets in Financial Instruments Directive (MiFID II) took effect in January 2018. Whilst the majority of the regulation is not applicable to retail banks, some areas such as transaction reporting require TSB Group to make changes to processes within its Treasury function which are being addressed.

Stress testing

TSB Group uses stress testing and scenario analysis to assess and support the delivery of business strategy. This allows senior management and the Board to assess the impact of adverse macroeconomic scenarios and take appropriate management actions if required to ensure that business plans will not breach TSB Group's risk appetite. Such testing includes stress tests for capital and liquidity regulatory submissions, the ICAAP, the ILAAP and Recovery and Resolution planning. TSB Group's stress testing also covers adverse situations in the wider operating environment to assess market risk sensitivities, financial market disruption, and operational risks. Reverse stress testing is undertaken to understand the kinds of stress that would cause TSB Group to fail, understand the path to failure and help to prepare mitigants and early warning indicators. All outputs are subject to a robust governance process prior to Board approval.

Risk Management in TSB (continued)

Going concern

The Directors recognise their responsibility to make an assessment of TSB Group's ability to continue as a going concern for a period of at least twelve months from the date the financial statements are approved. As noted on page 42, the Directors consider that it is appropriate to adopt the going concern basis in preparing the consolidated financial statements.

Viability statement

As more fully explained in the corporate governance statement on page 25, the Directors consider that it is appropriate to voluntarily adopt the principles of the UK Corporate Governance Code issued by the Financial Reporting Council (FRC) which includes provisions that require the Directors to:

- carry out a robust assessment of the principal risks facing the Company;
- explain how they have assessed the prospects of the Company, over what period, and why they consider that period to be appropriate; and
- state whether they have a reasonable expectation that the Company and TSB Group will be able to continue in operation and meet their liabilities, taking account of their current position and principal risks, over this period.

Robust assessment of principal risks

The Chief Risk Officer (CRO) presents a regular analysis of the principal risks arising from TSB Group's business model, strategy and the external economic and competitive environment to the Bank Executive Committee and Board. The Directors receive a regular report on internal and external developments from the CRO to enable them to monitor the principal risks, and changes to them, in the context of the Board approved risk appetite.

The Board and Board Committee meetings provide a forum where the Directors debate and provide robust challenge of the analysis prepared by the CRO. The Directors seek to ensure that the analysis is complete, that the potential consequences of the principal risks are properly understood and that actions to mitigate the risks are appropriate. Further information on the principal risks and uncertainties are set out on pages 10 to 13.

Approach to assessment of prospects and period of viability assessment

Guidance from the FRC states that the period assessed under the viability statement should be significantly longer than 12 months from the date of approval of the financial statements, which is the period over which going concern is assessed.

For TSB Group, the Directors have assessed viability to December 2021. The assessment has been made over this period as it is within the period over which TSB Group's medium term strategic and financial plan is prepared, key capital and leverage ratios are forecast and regulatory and internal stress testing of the profit, capital and funding forecasts are carried out. The period takes into account the residual term of TSB Group's non-customer funding sources under securitisation and covered bond programmes and the Bank of England's Term Funding Scheme.

In developing the plan, key risks considered included future economic uncertainty, the risk to TSB's business model from market-led competition and regulatory developments, and the execution risk inherent in the plan. A number of sensitivities were considered including downside risks from lower interest rates and higher wholesale funding costs. The assessment period takes into account the increasing uncertainty of forecasts in the outer years of the planning horizon reflecting these risks.

Approach to assessing viability and going concern

The Directors' assessment of viability is integrated into the existing approach to the going concern assessment. In making the viability assessment, the Directors have considered a wide range of information relating to present and future conditions, including future projections of profitability, capital requirements, capability, resources and funding. In addition, the Directors assessed the top and emerging risks that could threaten TSB Group's future prospects and business model more broadly and the monitoring and mitigation activities around them, as outlined above.

Viability assessment

The viability assessment is based on TSB Group having sufficient liquidity and capital, and includes consideration of its funding and capital plans and the ILAAP and ICAAP approved annually by the Board. The Directors confirm that:

- they have carried out a robust assessment of the principal risks facing TSB Group, including those that would threaten its business model, future performance, solvency or liquidity; and
- in light of TSB Group's capital and funding resources (pages 16 to 18) they have a reasonable expectation that TSB Group will be able to continue in operation and meet its liabilities as they fall due in the period to December 2021.

Review of our performance

TSB Group's performance is presented on a statutory basis, prepared using accounting policies described on page 61.

Review of performance

The review of our performance in 2017 is structured in a manner consistent with the key elements of TSB Group's business model as explained on page 7.

Balance sheet, funding and capital

	Analysis	2017 £ million	2016 £ million
Customer deposits		**30 520.6**	29,383.8
Non customer funding		**8,796.1**	4,763.0
Total funding resources		**39,316.7**	34,146.8
Shareholder's equity		**1,995.6**	1,865.0
Sources of funding	Page 16	**41,312.3**	36,016.8
Other liabilities		**1,213.2**	1,178.9
Total equity and liabilities		**42,525.5**	37,195.7
Loans and adv to customers	Page 19	**30,854.2**	29,419.1
Liquidity portfolio	Page 19	**9,536.2**	5,571.4
Other assets		**2,135.1**	2,205.2
Total assets		**42,525.5**	37,195.7

Total sources of funding increased by £5.3 billion to £41.3 billion reflecting:

- an increase in, and diversification of, the sources of non-customer funding in 2017 primarily driven by £5.6 billion of borrowing from the Bank of England's Term Funding Scheme, and £0.5 billion of covered bonds issuance, offset by repayment of the £1.9 billion Cape Funding facility from LBG; and
- strong customer deposit net inflow, increasing by over £1.1 billion during the year.

This increased funding supported TSB Group's strategic aim to help more people borrow well and funded:

- an increase of £1.4 billion in loans and advances to customers; and
- an increase of £4.0 billion in the liquidity portfolio.

Profitability (statutory basis)

Income Statement		2017 £ million	2016 £ million
Net interest income	Page 21	**905.3**	853.8
Other net income	Page 21	**194.5**	146.6
Operating expenses	Page 22	**(859.3)**	(731.1)
Impairment	Page 22	**(77.8)**	(87.3)
Statutory profit before tax		**162.7**	182.0
Taxation	Page 22	**(44.0)**	(54.2)
Statutory profit after tax		**118.7**	127.8

On a statutory basis, profit before tax decreased by £19.3 million to £162.7 million. The reduction was primarily driven by:

- a £122.0 million increase in outsourcing fees, within operating expenses, paid to LBG in 2017; and
- a non-repeating gain in 2016, within other income, of £32.5 million on the sale of the Visa Europe share.

The above factors, that decreased statutory profit before tax, were partially offset by:

- a £96.0 million increase in net interest income from the Franchise (including Whistletree) portfolio driven by secured balance growth of 12.1%; and
- a £15.5 million increase in profits earned from the Mortgage Enhancement portfolio. This increase reflected the effect of the portfolio's early return to LBG in June 2017 generating a gain at the date of its return of £49.7 million.

Profitability (management basis)

In previous years, profit performance was analysed on a segmental basis, consistent with how TSB Group was then organised, managed and reported internally. The segments reported internally were as follows:

- *Franchise:* comprising the UK retail banking business which offers a range of retail financial services including current accounts, savings products, personal loans, credit cards and mortgages.
- *Whistletree Loans:* a separate portfolio of former Northern Rock mortgages and unsecured loans which was acquired with effect from 7 December 2015 and which at 31 December 2017 had total customer loan balances of £2.1 billion.
- *Mortgage Enhancement:* a separate portfolio of mortgage assets which was assigned to TSB Group in 2014. The portfolio was returned early to LBG in June 2017, having achieved its profit target.

During 2017, the Whistletree and Franchise segments were combined, reflecting the direct nature of the relationship between TSB and Whistletree branded customers. In contrast, the Mortgage Enhancement segment, where TSB Group had a beneficial interest in the portfolio but no customer relationship, continued to be reported as a separate segment until it was divested in June 2017.

Segmental results are presented below on a management basis to exclude certain volatile and one-off items which enables a more meaningful assessment of TSB Group's underlying financial performance.

By Segment	2017 £ million	2016 £ million
Franchise – including Whistletree	**119.7**	131.5
Mortgage Enhancement (to June 17)	**61.7**	46.2
Management profit before tax	**181.4**	177.7
Gain on sale of share in Visa Europe	**–**	32.5
Migration costs	**(19.8)**	–
Other one-off items	**(9.0)**	(30.4)
Banking volatility	**10.1**	2.2
Statutory profit before tax	**162.7**	182.0

Sources of funding

Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets and equity invested by the shareholder.

	2017 £ million	2016 £ million	Change %
Customer deposits	**30,520.6**	29,383.8	3.9
Non-customer funding:			
Term Funding Scheme	**5,625.7**	5.0	–
Repurchase agreements	**1,446.4**	1,409.6	2.6
Debt securities in issue	**1,318.7**	2,940.1	(55.1)
Subordinated liabilities	**405.3**	413.3	(1.9)
Total non-customer funding	**8,796.1**	4,768.0	84.5
Funding resources	**39,316.7**	34,151.8	15.1
Shareholder's equity	**1,995.6**	1,865.0	7.0
Total sources of funding	**41,312.3**	36,016.8	14.7

Sources of funding

Total sources of funding increased by 14.7% to £41.3 billion, reflecting increases in both customer and non-customer funding.

Customer Deposits

Customer deposits increased by £1.1 billion to £30.5 billion, due to growth in current account balances supported by the ongoing success of the 'Classic Plus' account which contributed to TSB Group opening 6.2% of all new and switching personal banks accounts in the UK during 2017, above our ongoing target of 6%.

Non-customer funding

Non customer funding increased by £4.0 billion or 84.7% to £8.8 billion, and reflected aggregate borrowing of £5.6 billion from the Bank of England's Term Funding Scheme (TFS). The TFS provides four year term funding to UK banks at rates at or close to Bank Base Rate.

The increased funding from the TFS was partially offset by repayment of:

- £1.9 billion of borrowings under the Cape Funding securitisation facility provided by LBG in February 2017; and
- £750 million of funding, raised under an 18 month repurchase agreement facility collateralised using retained notes issued by Duncan Funding 2015-1 plc in July 2017.

In addition, during 2017, TSB Group established a covered bond programme and in December completed its inaugural issuance, raising £500 million of 5 year funding.

Cost of funding resources

The cost of customer deposits reduced significantly to 0.40% in 2017 (2016: 0.66%). Savings deposit interest costs reduced to 0.48% (2016: 0.72%) reflecting lower fixed rate balances and the lower cost of existing variable rate deposits across the industry following the introduction of TFS funding.

Bank account interest costs decreased to 0.24% (2016: 0.53%) reflecting the changes to the Classic Plus account from January 2017. From this date interest was paid at a rate of 3% on balances up to £1,500. Prior to this date, interest had been paid at a rate of 5% on balances up to £2,000. The decrease in interest cost also reflected continued growth in the proportion of non-interest bearing bank account balances.

Capital resources

TSB Group's capital position remains strong with a Common Equity Tier 1 (CET1) Capital ratio of 20.0% and a leverage ratio of 4.5% which is sufficient to support the delivery of TSB Group's growth strategy. The movement in the year primarily reflects profits earned during 2017.

Sources of funding (continued)

Capital ratios

The CET 1 capital ratio increased by 160bps to 20.0% at December 2017 primarily due to attributable profit of £118.7 million earned in 2017.

	At 31 Dec 2017 £ million	At 31 Dec 2016 £ million
Shareholder's equity per balance sheet	**1,995.6**	1,865.0
Excess of regulatory expected losses over impairment provisions	**(84.8)**	(73.5)
Cash flow reserve regulatory adjustment	**0.5**	(0.4)
Prudent valuation prudential filter adjustment	**(3.0)**	(3.1)
Intangible assets	**(10.2)**	(2.6)
Common Equity Tier 1/Total Tier 1 capital (fully loaded*)	**1,898.1**	1,785.4
Tier 2 capital (fully loaded*)	**384.1**	383.9
Total capital resources (fully loaded*)	**2,282.2**	2,169.3
Risk-weighted assets (RWA)	**9,490.7**	9,681.7
Common Equity Tier 1/Total Tier 1 capital ratio (fully loaded*)	**20.0%**	18.4%
Total Capital ratio (fully loaded*)	**24.0%**	22.4%

* TSB Group's capital is reported on a fully loaded basis. TSB Group's capital is compliant with Capital Requirements Regulation (CRR) and not subject to transitional adjustments.

The movements in CET 1/ Total Tier 1, Tier 2 and Total Capital in the year are shown below:

	CET 1/ Total Tier 1 £ million	Tier 2 £ million	Total resources £ million
At 31 December 2016	**1,785.4**	**383.9**	**2,169.3**
Profit attributable to ordinary shareholder	**118.7**	**–**	**118.7**
Change in excess of regulatory expected losses over impairment provisions	**(11.4)**	**–**	**(11.4)**
Change in excess of default provision over default expected loss	**–**	**(0.1)**	**(0.1)**
Movement in other comprehensive income	**11.9**	**–**	**11.9**
Change in intangible assets	**(7.5)**	**–**	**(7.5)**
Movement in tier 2 subordinated liabilities	**–**	**0.3**	**0.3**
Cash flow hedging reserve regulatory adjustment	**0.9**	**–**	**0.9**
Movement in prudent valuation prudential filter adjustment	**0.1**	**–**	**0.1**
At 31 December 2017	**1,898.1**	**384.1**	**2,282.2**

Risk-weighted assets (CRD IV)

RWAs at 31 December 2017 decreased by £192.1 million (2.0%) compared to December 2016 due to effect of the early return of the Mortgage Enhancement portfolio, the ongoing and expected repayment of the Whistletree loan portfolio, and lower balances held with other institutions, partially offset by growth in the Franchise IRB portfolio.

	At 31 Dec 2017 £ million	At 31 Dec 2016 £ million
Risk type analysis of risk-weighted assets:		
Franchise standardised approach	**846.2**	828.5
Franchise IRB approach	**6,095.1**	5,453.3
Whistletree Loans standardised approach	**966.1**	1,131.3
Total Franchise – including Whistletree	**7,907.4**	7,413.1
Mortgage Enhancement standardised approach	**–**	654.2
Total credit risk	**7,907.4**	8,067.3
Operational risk	**1,463.7**	1,407.8
Counterparty risk	**119.6**	206.6
Total risk-weighted assets	**9,490.7**	9,681.7

IFRS 9 impact on capital

As explained on page 80, with effect from 1 January 2018, TSB Group adopted IFRS 9 *Financial Instruments*. This is expected to result in an increase in the allowance for loan losses of £96 million at 1 January 2018 which, after tax, would reduce shareholder's equity by £72 million. The impact on TSB Group's regulatory capital position at 1 January 2018 is not expected to be significant, as the effect of the increase in impairment allowance is more than offset by a reduction in excess expected losses and the effect of optional transitional arrangements permitted by regulators to absorb the full impact of IFRS 9 in regulatory capital calculations over the five year period to 2022. As a result, the adoption of IFRS 9 is expected to result in a decrease in the CET 1 ratio at 1 January 2018 of circa 2 bps, on a fully loaded basis, and an increase of circa 10 bps on a transitional basis.

Sources of funding (continued)

Leverage ratio

The leverage ratio measure is defined as the ratio of Tier 1 capital to total exposure. This is intended to complement the risk based capital requirements with a simple, non-risk based 'backstop' measure. TSB Group calculates its leverage ratio based on the exposure measure in the revised Basel III leverage ratio framework published in January 2014 and adopted in the Capital Requirements Regulation (CRR) and the CRR definition of Tier 1.

	At 31 Dec 2017 £ million	At 31 Dec 2016 £ million
Total Tier 1 Capital for leverage ratio (fully loaded)	**1,898.1**	1,785.4
Exposures for leverage ratio		
Total statutory balance sheet assets	**42,525.5**	37,195.7
Removal of accounting value for derivatives	**(214.8)**	(247.5)
Exposure value for derivatives and securities financing transactions	**(233.2)**	(80.7)
Off-balance sheet	**690.1**	798.3
Other regulatory adjustments	**(99.0)**	(79.6)
Total exposures	**42,668.6**	37,586.2
Leverage ratio	**4.5%**	4.8%

The leverage ratio of 4.5% exceeds the Basel Committee's proposed minimum of 3% applicable from 2018.

Loans

Funds deposited with TSB are used to support lending to customers who wish to borrow. A portion of funds are held in reserve, in the form of a liquidity portfolio, to meet any unexpected funding requirements.

Loans and advances to customers	2017 £ million	2016 £ million	Change %
Secured	**26,314.7**	22,867.9	15.1
Unsecured and business banking	**2,430.1**	2,222.4	9.3
Whistletree Loans	**2,109.4**	2,479.9	(14.9)
Total Franchise – including Whistletree	**30,854.2**	27,570.2	11.9
Mortgage Enhancement	**–**	1,848.9	–
Total loans and advances to customers	**30,854.2**	29,419.1	4.9
Liquidity portfolio			
Balances at central banks[(1)]	**7,419.9**	3,473.1	113.6
Gilts (available-for-sale)[(2)]	**1,721.5**	1,872.8	(8.1)
Supranational and development bank bonds (available-for-sale)	**394.8**	225.5	75.1
Total liquidity portfolio	**9,536.2**	5,571.4	71.2

(1) Balances at central banks are combined with other cash balances and demand deposits of £143.9 million (2016: £174.6 million) when shown on TSB Group's consolidated balance sheet on page 64.

(2) Of which £1,444.7 million (2016: £663.8 million) were sold under repurchase agreements but not derecognised from TSB Group's consolidated balance sheet (see note 4 to the consolidated financial statements on page 70).

Loans and advances to customers

Loans to customers increased by 4.9% to £30.9 billion driven by strong growth in Franchise secured lending, partially offset by the early return of the Mortgage Enhancement portfolio and the ongoing and expected repayment of the Whistletree loan portfolio. The growth in Franchise secured loans reflected the continued success of TSB's mortgage broker service where £5.4 billion of completions represented an increase of 6.9% on 2016.

Liquidity portfolio

The Group's liquidity portfolio comprises highly liquid assets, primarily cash deposits at the Bank of England, UK gilts and supranational and development bank bonds available and immediately accessible to meet potential cash outflows. The liquidity portfolio increased by 71.2% to £9.5 billion at December 2017, with the additional funding provided by the borrowings from the TFS contributing to an increase in the surplus over regulatory requirements as noted below.

TSB Group's liquidity position is managed centrally by TSB Group's Treasury function and is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of TSB Group's liquidity management process. A key regulatory measure of liquidity adequacy is the Liquidity Coverage Ratio (LCR). This is designed to promote the short term resilience of TSB Group's liquidity risk profile and is regularly monitored and forecast alongside other cash flow and liquidity ratios. At 31 December 2017, the LCR was 295.3% (2016: 171.0%). This compares to the minimum regulatory requirement of 90% set by the PRA, which increased to 100% from 1 January 2018.

Interest rates earned on loans

In 2017, the average rate earned on Franchise – including Whistletree lending reduced to 3.22% (2016: 3.56%). This decrease was attributable to mortgage growth increasing the proportion of secured loans relative to higher margin unsecured loans, and the impact of competition.

The average rate earned on Franchise and Whistletree mortgages reduced to 2.62% (2016: 2.85%). Lower rates were earned on the fixed rate portion of the portfolio, reflecting lower funding costs and increased competition in the market. Yields on unsecured lending decreased to 10.24% (2016: 11.34%), reflecting sustained competition within the unsecured lending market.

Loans (continued)

Encumbered assets

TSB Group manages the quantity of assets that have been used to support wholesale funding activities. The table below summarises the extent to which assets have been encumbered. The decrease in amounts encumbered with counterparties other than central banks during 2017 reflects the repayment of the £1.9 billion of borrowings under the Cape Funding securitisation facility, as described on page 16, partially offset by increased encumbrance to support the covered bond programme.

		Other Assets				
		Assets positioned at central banks (pre-positioned plus encumbered)	Assets not positioned at central banks			
	Assets encumbered with counterparties other than central banks £ million		Readily available for encumbrance £ million	Capable of being encumbered £ million	Unencumbered-cannot be used £ million	Total Assets
		£ million				
Cash, cash balances with central banks and other demand deposits	**–**	**7,419.9**	**–**	**–**	**143.9**	**7,563.8**
Available-for-sale financial assets	**1,444.7**[1]	**–**	**671.6**	**–**	**7.0**	**2,123.3**
Loans and Receivables:						
Loans to central banks	**–**	**56.0**	**–**	**–**	**–**	**56.0**
Loans to credit institutions	**329.2**[2]	**–**	**–**	**–**	**–**	**329.2**
Loans to customers	**1,547.1**[3]	**7,771.9**	**4,005.1**	**17,530.1**	**–**	**30.854.2**
Other advances	**635.6**[4]	**–**	**–**	**–**	**260.4**	**896.0**
Remainder of assets	**–**	**–**	**–**	**–**	**703.0**	**703.0**
Total – December 2017	**3,956.6**	**15,247.8**	**4,676.7**	**17,530.1**	**1,114.3**	**42,525.5**
Total – December 2016	6,014.6	11,290.7	4,286.3	12,712.4	2,891.7	37,195.7

(1) Gilts sold under repurchase agreements and pledged as collateral – see note 11 to the consolidated financial statements.
(2) Cash held on deposit by the securitisation and covered bond subsidiary entities.
(3) Mortgage loans encumbered in support of external securitisation notes and covered bond issuance.
(4) Cash collateral placed with counterparties in respect of TSB Group's derivative financial liabilities.

Income

We earn income in the form of interest that we receive on the loans we make to customers, and we pay interest to savings and bank account customers on the money they deposit with us. We also earn other income in the form of fees and charges for the provision of other banking services and commissions from the sale of certain products such as general insurance.

Net interest income

	2017 £ million	2016 £ million	Change %
Franchise – including Whistletree	**910.3**	814.3	11.8
Mortgage Enhancement	**15.6**	52.5	(70.3)
Management basis net interest income	**925.9**	866.8	6.8
Net interest income on derivatives not in hedge relationships*	**(20.6)**	(13.0)	(58.5)
Statutory net interest income	**905.3**	853.8	6.0

* Included in Management basis net interest income but is recognised in other income for statutory purposes.

Segmental margins	2017 %	2016 %	Change Bps
Group banking net interest margin	**3.02%**	3.09%	(7)bps
Franchise (including Whistletree) banking net interest margin	**3.04%**	3.13%	(9)bps
Mortgage Enhancement banking net interest margin	**2.12%**	2.56%	(44)bps

Net interest income increased by 6.0% to £905.3 million, primarily reflecting the growth in average mortgage loan balances year on year, partially offset by the early return, in June 2017, of the Mortgage Enhancement portfolio.

The increase in Franchise (including Whistletree) net interest income was predominantly driven by the 12.1% growth in Franchise mortgage balances and reflected the continued success of TSB Group's mortgage broker service, partly offset by expected repayments within the closed Whistletree portfolio. The effect of balance growth was partially offset by a 7bps reduction in net interest margin, driven by increased competition in mortgages and unsecured lending driving down yields.

Other income

	2017 £ million	2016 £ million	Change %
Franchise – including Whistletree	**108.5**	108.3	0.2
Mortgage Enhancement	**46.1**	(6.3)	–
Management basis other income	**154.6**	102.0	51.6
Net interest income on derivatives not in hedge relationships*	**20.6**	13.0	58.5
Banking volatility	**13.5**	1.7	–
One off items	**5.8**	(2.6)	–
Gain on sale of share in Visa Europe	**–**	32.5	–
Statutory other income	**194.5**	146.6	32.7

* Included in Management basis net interest income but is recognised in other income for statutory purposes.

Other income increased by 32.7% to £194.5 million (2016: £146.6 million) driven by the recognition of a gain of £49.7 million from the early return of the Mortgage Enhancement portfolio in June 2017. Partially offsetting this increase was the recognition, in 2016, of a one-off gain of £32.5 million from the sale of TSB Group's share in Visa Europe.

Charges

Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our TSB Partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the bank in the form of our impairment charge. Finally, TSB Group pays tax to Her Majesty's Revenue and Customs (HMRC).

Operating expenses

	2017 £ million	2016 £ million	Change %
TSB Partner related costs	**352.7**	353.2	(0.1)
Regulatory and professional costs	**24.5**	26.0	(5.8)
Operational and IT costs	**42.8**	37.5	14.1
Marketing costs	**58.1**	57.1	1.8
Property costs	**93.5**	95.1	(1.7)
Investment costs	**26.0**	33.5	(22.4)
Transitional Service Agreement (TSA) costs	**213.8**	91.8	132.9
Other	**9.9**	9.6	3.1
Management basis operating expenses excluding one off items	**821.3**	703.8	16.7
One-off items	**35.8**	27.8	28.8
Banking volatility	**2.2**	(0.5)	
Statutory operating expenses	**859.3**	731.1	17.5

Operating expenses increased by 17.5% to £859.3 million reflecting the £122.0 million contractual increase in outsourcing fees paid to LBG. Excluding this factor, costs were broadly flat. The £8.0 million increase in one-off items is predominantly due to higher migration related spend in 2017, being largely offset by a decrease of £7.5 million in investment expenditure as TSB Group scaled back on projects to prioritise IT migration activity.

Impairment charge

	2017 £ million	2016 £ million	Change %
Mortgages	**1.0**	7.5	(86.7)
Personal unsecured	**77.7**	74.7	4.0
Business banking	**0.5**	0.6	(16.7)
Whistletree	**(1.4)**	4.5	
Total Franchise - including Whistletree	**77.8**	87.3	(10.9)
Mortgage Enhancement	**–**	–	
Total impairment charge	**77.8**	87.3	(10.9)
Asset quality ratio	**0.25%**	0.31%	(6)bps

The impairment charge decreased by 10.9% to £77.8 million primarily reflecting an improved outlook, relative to 2016, for UK house prices, partly offset by a decrease in expected recovery rates from unsecured products. Further information on the credit risk of TSB Group's financial assets is set out in Note 23 to the consolidated financial statements.

Taxation

The tax charge of £44.0 million (2016: tax charge of £54.2 million) reflects an effective tax rate of 27.04%, which is consistent with the applied UK corporation tax rate in 2017 of 27.25%. The applied tax rate in 2017 comprises the 19.25% average UK corporation tax rate and the 8% bank surcharge applicable to taxable profits in excess of £25 million per annum.

The tax charge in 2016 reflected an effective tax rate of 29.78%. This was slightly higher than the applied UK corporation tax rate of 28% in 2016 and was primarily driven by the non-deductibility of certain costs, including property and restructuring costs.

A reconciliation of the tax charge to that which would have resulted from using the UK corporation tax rate is set out in note 19 to the consolidated financial statements.

Profits and returns to the shareholder

The Board reviews TSB Group's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB Group faces, or returned to the shareholder in the form of dividends. Currently all returns are being reinvested in the business.

As described on page 15, during 2017, the Whistletree and Franchise segments were combined, reflecting the direct nature of the relationship between TSB and Whistletree branded customers. TSB Group's Executive Committee and Board reviewed the results and considered the performance of TSB Group across two segments: Franchise (including Whistletree) and Mortgage Enhancement. Following the early return of the Mortgage Enhancement portfolio in June 2017, the results and performance of TSB Group is reviewed as a single segment UK banking business.

Year ended 31 December 2017	Franchise-including Whistletree £ million	Mortgage Enhancement £ million	Total £ million
Net interest income	**910.3**	**15.6**	**925.9**
Other income	**108.5**	**46.1**	**154.6**
Total income	**1,018.8**	**61.7**	**1,080.5**
Operating expenses	**(821.3)**	**–**	**(821.3)**
Impairment	**(77.8)**	**–**	**(77.8)**
Management basis profit before taxation (excluding one off items)	**119.7**	**61.7**	**181.4**
One-off items			**(28.8)**
Banking volatility			**10.1**
Statutory profit before taxation			**162.7**
Year ended 31 December 2016			
Net interest income	814.3	52.5	866.8
Other income/(expense)	108.3	(6.3)	102.0
Total income	922.6	46.2	968.8
Operating expenses	(703.8)	–	(703.8)
Impairment	(87.3)	–	(87.3)
Management basis profit before taxation	131.5	46.2	177.7
Gain on sale of share in Visa Europe			32.5
One-off items			(30.4)
Banking volatility			2.2
Statutory profit before taxation			182.0

Key balance sheet items at 31 December 2017	£ million	£ million	£ million
Loans and advances to customers	**30,854.2**	**–**	**30,854.2**
Customer deposits	**30,520.6**	**–**	**30,520.6**
Key balance sheet items at 31 December 2016			
Loans and advances to customers	27,570.2	1,848.9	29,419.1
Customer deposits	29,383.8	–	29,383.8

Franchise (including Whistletree) management basis profit before taxation decreased by 9.0% to £119.7 million as a result of the contractual increase in LBG support costs, offsetting strong secured lending performance through TSB's broker service.

Mortgage Enhancement management basis profit before taxation increased by £15.5 million due to the gain recognised on the early return of the portfolio to LBG.

One off items excluded from the management basis results of £28.8 million (2016: £30.4 million) primarily reflect costs associated with migration and integration and the costs associated with restructuring the branch network.

Strategic report on pages 2 to 23 approved, by order of the Board:

Lorna Curry
Company Secretary,
1 February 2018

Corporate governance statement

How the business is managed

The design and operation of a robust corporate governance framework appropriate for a bank of TSB's scale and ambition is critical to meeting the needs of all our stakeholders. The Corporate Governance Framework encompasses TSB Banking Group plc (the Company), TSB Bank plc (the Bank) and any other subsidiaries of the Company from time to time (together TSB Group or TSB). Each Director of the Company also serves as a Director of the Bank. Will Samuel is the Chairman of the Boards of both the Company and the Bank. The Board of the Company (the Board) as a whole is collectively responsible to the shareholder for promoting the long term success of the Company by directing the Company's affairs. The Corporate Governance Framework is designed to assist the Board, the Board of the Bank and the Chief Executive Officer in discharging their duties by ensuring an appropriate scheme of delegation. This is achieved through:

- Board authorities being delegated from the Boards of the Company and the Bank to Board committees and to the Chief Executive Officer; and
- Delegated executive authorities through which the Chief Executive Officer delegates aspects of his own authority to other senior executives and sets out the support provided to him by the executive committees.

The corporate governance structure is supported by the Internal Control and Governance Framework as outlined on pages 31 and 32. An important principle, applied throughout the Company's governance framework, is that the delegation of executive authority is to the individual office holders (who may in turn delegate aspects of their authority to others). Executive committees may be established to support the individuals in exercising their delegated authorities but the committees do not separately hold any delegated authority in their own right. This approach of individual accountability is aligned to the principles of the Senior Managers Regime, which was fully implemented by TSB during the course of 2016.

Whilst the Bank continues to operate as a ring-fenced UK bank, it is also part of a wider group, comprising Banco de Sabadell, S.A. (Sabadell) and its subsidiaries (together the Sabadell Group) and is required to adhere to relevant Sabadell Group policies, in addition to any relevant obligations imposed by Sabadell Group's regulators, the Bank of Spain and the European Central Bank.

To assist with this, Sabadell operates two information sharing and co-ordination committees which seek to ensure that TSB Group policies and processes are aligned to those of the Sabadell Group where it is appropriate to do so. Certain members of the Bank Executive Committee are also appointed as members of these committees.

Although the Company no longer has shares with a premium listing on the London Stock Exchange, the Board has committed to voluntarily adopt the principles of the UK Corporate Governance Code 2016 (the Code), where it is appropriate to do so as a wholly owned subsidiary of Sabadell. A copy of the Code is available at www.frc.org.uk.

The following aspects of the Code are not considered appropriate for TSB:

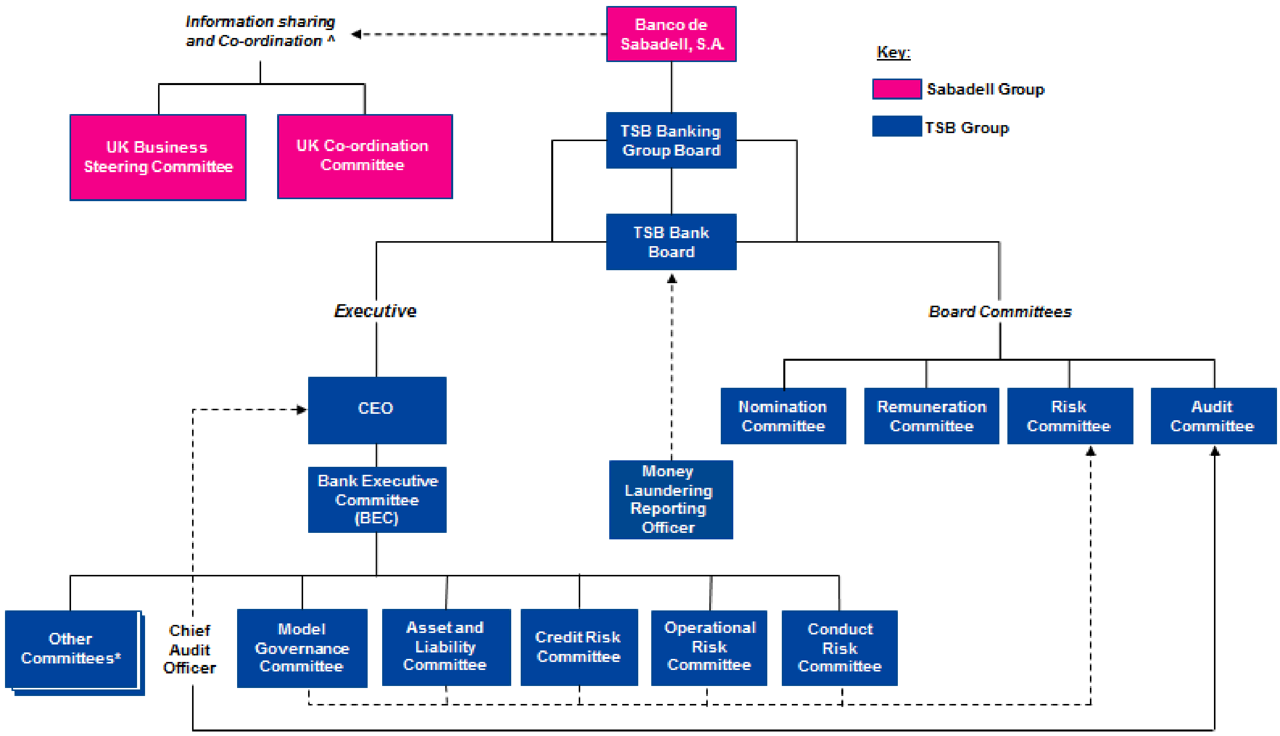
- All Directors should be subject to annual election by shareholders (B.7.1 and B.7.2).
- Provisions relating to the proportion of Independent Non-executive Directors who are members of the Nomination, Audit and Remuneration Committees (B.2.1 / C.3.1 / D.2.1).
- Provisions relating to dialogue with shareholders (E.1) and constructive use of General Meetings (E.2).

In addition, Directors appointed at the nomination of Sabadell have not been appointed for a specified term as recommended by the Code (B.2.3).

How the business is managed (continued)

The Corporate Governance Framework is reviewed at least annually by the Board to confirm that governance arrangements are and remain effective.

The Company is a wholly owned subsidiary of Sabadell. The diagram below sets out the framework of Board and Executive Committees.



^ The information sharing and co-ordination committees are Sabadell Group Committees. Membership of these committees includes TSB Group Executives. The UK Business Steering Committee discusses TSB products, distribution, financial performance updates and other matters at Sabadell's request. The UK Co-ordination Committee's purpose is to co-ordinate TSB's corporate policies and align decision making on relevant TSB activity.

* Includes Product Pricing Committee, Executive Product and Sales Process Governance Committee, Spend Wise Committee, and Disclosure Committee.

The role and responsibility of the Board

The Board's full responsibilities are set out in the matters reserved for the Board, the main items of which are summarised below.

(i) Strategy

- Approving TSB Group's strategy and long term objectives and ensuring that rigorous and robust processes are in place to monitor organisational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations;
- Determining Board structure, size and composition for the Company and Bank, succession planning for members of the Company and Bank Boards and committees, determining the roles of Chairman, Senior Independent Director, Non-executive Directors, Chief Executive Officer and Executive Directors;
- Approving the high level framework of Board delegations;
- Approving new TSB Group contracts where the cost impact exceeds £10 million and renewal of existing contracts where the cost impact exceeds £20 million;
- Approving the acquisition or disposal of assets or equity investments by the Company or any subsidiary of the Company, where the consideration exceeds £10 million; and
- Approving material changes to TSB Group corporate and organisational structure, including changes to the Company's listing status or its status as a plc.

How the business is managed (continued)

(ii) Risk

- Approval of TSB Group's strategy and long term objectives and review of delivery of that strategy;
- Ensuring that rigorous and robust processes are in place to monitor organisational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations;
- Reviewing the effectiveness of the Company's and Bank's risk management and internal control systems; and
- Approval of the Bank's Risk Appetite, ICAAP, ILAAP, Reverse Stress Test and Recovery Plan.

(iii) Shareholder communications

- Approving the financial statements and the annual report and accounts;
- Approving TSB Group's dividend policy; and
- Approving the resolutions and associated documentation for the shareholder at a general meeting.

In accordance with the Company's articles of association, Sabadell is empowered to determine that certain matters reserved to the Board of the Company also require approval by Sabadell.

Role of Directors

There is a clear division of responsibility between the Chairman and Chief Executive Officer, approved by the Board.

(i) Chairman

The Chairman is responsible for leadership of the Board and Bank Board and is pivotal in creating the conditions for overall Board and individual Director effectiveness. The Chairman's key accountabilities are as follows:

- Building an effective Board with complementary skills and experience;
- Running the Board and setting its agenda;
- Ensuring the Board members receive accurate, timely and clear information;
- Managing the Board and encouraging a culture of openness and debate;
- Ensuring effective communication with the shareholder;
- Encouraging active engagement by all Board members;
- Holding meetings with the Non-executive Directors without the Executive Directors present;
- Demonstrating effective leadership; and
- Upholding the highest standards of integrity, probity and corporate governance.

(ii) Chief Executive Officer

The Chief Executive Officer is responsible for running the business and has the following key responsibilities and accountabilities:

- Leading the formulation of TSB Group's strategy;
- Co-ordinating activities to implement strategy and for managing the business in accordance with TSB Group's risk appetite and business plan approved by the Board;
- Making decisions in all matters affecting the operations, performance and strategy of the business, with the exception of those matters reserved to the Board or specifically delegated by the Board to its committees;
- Establishing, maintaining and implementing the risk management and funding and liquidity frameworks in line with approved risk appetite;
- The continuing review of the organisational structure of TSB Group and making recommendations for changes to optimise the adequacy and use of resources; and
- Setting the tone at the top in relation to culture, ethos and corporate social responsibility.

Other than matters expressly reserved to the Chief Executive Officer, authority can be delegated to the respective Bank Executive Committee members, jointly or severally.

(iii) Non-executive Directors

The role of the Non-executive Directors includes the following key elements:

- Providing constructive challenge to management and helping to develop strategy;
- Scrutinising the performance of management in meeting agreed goals and objectives and monitoring the reporting of performance;
- Satisfying themselves on the integrity of financial information and that financial controls and risk management systems are robust and defensible; and
- Determining appropriate levels of remuneration for Executive Directors and other senior management and having a prime role in appointing and, where necessary, removing Executive Directors and in succession planning.

How the business is managed (continued)

(iv) Senior Independent Director

The Senior Independent Director's role is defined as follows:

- Acting as a sounding board for the Chairman and to serve as an intermediary for the other Directors when necessary;
- Being available to the shareholder if it has concerns which cannot otherwise be resolved;
- Chairing meetings in the absence of the Chairman; and
- Reviewing the Chairman's performance.

Board membership and composition

As at the date of this report the Board has twelve members and is comprised as follows:

Non-executive Chairman:	Will Samuel (independent on appointment)
Executive Directors:	
Chief Executive Officer	Paul Pester
Chief Financial Officer	Ralph Coates
Independent Non-executive Directors:	Paulina Beato
	Dame Sandra Dawson (Senior Independent Director)
	Graeme Hardie
	Sandy Kinney
	Richard Meddings
	Stephen Page
	Polly Williams
Non-executive Directors:	Miquel Montes
	Tomás Varela

Full biographical details including their skills and experience are shown on pages 53 to 57. The letters of appointment for Non-executive Directors are available at the Company's registered office and at the Annual General Meeting.

Paulina Beato joined the Board as an Independent Non-executive Director on 22 March 2017. Richard Meddings and Stephen Page joined the Board as Independent Non-executive Directors on 20 September 2017.

Board Committees

Certain responsibilities of the Board and Board of the Bank are delegated to committees of the Board to assist the Board and Board of the Bank in carrying out their functions. The Risk Committee (chaired by Sandy Kinney) oversees the management of the risks TSB Group faces, the Audit Committee (chaired by Polly Williams) oversees financial reporting, internal control and management of the IT Migration Programme risks as they affect delivery of the programme and its objectives, the Nomination Committee (chaired by Will Samuel) leads the process for appointments to the Board and succession planning for the Board and Bank Executive Committee, and the Remuneration Committee (chaired by Dame Sandra Dawson) formulates TSB Group Remuneration Policy and supports the ongoing delivery of sustainable performance. The Audit and Nomination Committees have each prepared reports which include a description of their role, structure and composition. Each of the Board Committee's terms of reference is available at www.tsb.co.uk/investors/people/.

How the business is managed (continued)

Meeting attendance

The table below sets out attendance of Directors at Board meetings and the attendance of Committee members at the relevant Committee meetings held during the year.

Name of Director	Board meetings attended	Audit Committee meetings attended(iv)	Risk Committee meetings attended	Nomination Committee meetings attended	Remuneration Committee meetings attended
Will Samuel (iii)	13 out of 13	-	-	5 out of 6	-
Paul Pester	13 out of 13	-	-	-	-
Ralph Coates	13 out of 13	-	-	-	-
Paulina Beato (i), (iii)	11 out of 11	-	0 out of 1	-	2 out of 2
Dame Sandra Dawson (iii)	12 out of 13	-	-	6 out of 6	6 out of 6
Graeme Hardie	13 out of 13	11 out of 11	6 out of 6	-	-
Sandy Kinney (iii)	12 out of 13	11 out of 11	6 out of 6	-	-
Richard Meddings (ii), (iii)	5 out of 6	-	-	-	-
Stephen Page (ii)	6 out of 6	-	1 out of 1	-	-
Polly Williams	13 out of 13	11 out of 11	6 out of 6	-	6 out of 6
Miquel Montes	13 out of 13	-	-	6 out of 6	6 out of 6
Tomás Varela (iii)	12 out of 13	10 out of 11	5 out of 6	-	-

(i) Appointed to the Board on 22 March 2017.

(ii) Appointed to the Board on 20 September 2017.

(iii) Directors not able to attend meetings due to longstanding prior commitments, illness or unavoidable circumstances, provided comments to the relevant Chair on matters to be discussed at the relevant meeting.

(iv) The Audit Committee met 11 times during 2017, an increase from eight meetings during 2016, enabling the Committee to discharge its responsibilities to oversee the management of the risks associated with the IT Migration Programme as outlined on page 39.

Board development

Paulina Beato, Richard Meddings and Stephen Page have completed a comprehensive induction programme following their appointment to the Board as Independent Non-executive Directors. Additionally, Non-executive Directors are given the opportunity to request additional training in order that they are fully comfortable with their role within the Board and to enable them to be able to contribute to the operation of the Board and the long-term success of the Company in the fullest manner possible.

In addition, 'deep-dive' educational sessions are regularly held to allow Non-executive Directors to explore key strategic and risk issues outside of the time constraints of a formal Board meeting. A number of such sessions, run by relevant members of the Bank Executive Committee, were held during 2017 and covered topics including the IT Migration Programme, Competition Law, IFRS 9, Information and Cyber Security and the Senior Managers Regime. The Company Secretarial team, on behalf of the Chairman, maintains a schedule of all external training sessions and conferences attended by the Directors during the year.

How the business is managed (continued)

Board effectiveness

The review of Board effectiveness for 2017 was run internally by way of a self-assessment questionnaire. It was led by Dame Sandra Dawson in her role as Senior Independent Director and managed by the Company Secretarial team. The questionnaire was circulated to the Board together with selected members of the executive team who regularly attend Board meetings. The questionnaire required qualitative rather than quantitative responses to enhance the evaluation. The Company Secretarial team analysed and summarised responses for consideration by the Senior Independent Director and, ultimately, the Board. The results of the review concluded that the Board's performance continued to be effective and had matured during the course of 2017, whilst identifying areas where further improvements could be made.

The Board's Audit, Risk and Remuneration Committees have also conducted reviews of their own effectiveness during 2017. Each committee agreed a questionnaire which was circulated to committee members and other members of the executive team who regularly attend committee meetings. The results were analysed by the Company Secretarial team, discussed with the chair of the relevant Board committee and actions agreed for the coming year.

Independence

The Board has considered whether there are any relationships or circumstances which could appear to affect the Independent Non-executive Directors' judgement. No Independent Non-executive Director, or member of their immediate family, has ever had a material relationship with TSB Group nor receives additional remuneration apart from Director fees. The Independent Non-executive Directors do not participate in TSB Group's pension or share schemes. No Independent Non-executive Directors serve as Directors of any companies or affiliates in which any other Director is also a Director. Miquel Montes and Tomás Varela are members of Sabadell's Executive Committee and for that reason are not considered to be independent. They do not receive any fees from TSB Group.

Management of conflicts of interest

Each Director has a duty under the Companies Act 2006 to avoid a situation in which they have, or may have, a direct or indirect interest that conflicts, or might conflict, with the interests of the Company. This duty is in addition to the existing duty that Directors owe to the Company to disclose to the Board any interest in a transaction or arrangement under consideration by the Company. If Directors become aware of any situation which may give rise to a conflict of interest they must inform the rest of the Board immediately and the Board is then permitted under the articles of association to authorise such conflict. This information is recorded in the Company's register of conflicts together with the date on which authorisation was given. In addition, Directors are asked to certify, on an annual basis, that the information contained in the register is correct.

Save as set out below in relation to Miquel Montes and Tomás Varela, there are no conflicts of interest between any duties owed by the Directors to the Company and their private interests or other duties.

As Executive members of Sabadell, Miquel Montes and Tomás Varela will have a conflict of interest in circumstances where the interests of TSB Group and the wider Sabadell Group are not, or may not be, aligned. This conflict was authorised by the Board on 22 July 2015.

Whistleblowing arrangements

TSB Group has a robust whistleblowing process in place which is available to all Partners, with the Board delegating responsibility to the Board Audit Committee to provide challenge and oversight of these arrangements. Further details on this oversight are contained in the Audit Committee report on page 39.

How the business is managed (continued)

Reappointment of Directors

The Board considers that all Directors continue to be effective, committed to their roles and have sufficient time available to perform their duties. All Non-executive Directors, with the exception of Miquel Montes and Tomás Varela (being the Directors appointed at the nomination of Sabadell), have been appointed for an initial three year term and their continued appointment thereafter will be considered by the Board at the end of this initial period of office. During 2017, Will Samuel, Dame Sandra Dawson, Sandy Kinney and Polly Williams were all reappointed for a further period of office. As the Company is a wholly owned subsidiary of Sabadell it is not considered necessary for Directors to seek annual re-election or for the Directors appointed at the nomination of Sabadell to be appointed for a specified term.

Company Secretary and independent professional advice

The Company Secretary, Susan Crichton, retired on 24 January 2018 and was replaced by Lorna Curry. The Company Secretary is responsible to the Board for ensuring compliance with corporate governance requirements. The Board has access to her individually and collectively. As well as the support of the Company Secretary, any Director may take independent professional advice at the Company's expense in the furtherance of their duties, where considered necessary.

Evaluation of internal controls procedures

The Board has carried out an assessment of the effectiveness of the Company's risk management and internal control systems. The Audit Committee report explains the process in more detail on page 39.

External auditors

PricewaterhouseCoopers LLP (PwC) have expressed their willingness to continue as the Company's auditors. As outlined in the Audit Committee report on page 40, resolutions proposing their reappointment for 2018, and to authorise the Directors to determine their remuneration will be proposed at the 2018 Annual General Meeting, as recommended by the Audit Committee.

Principal accountant fees and services

An analysis of fees for professional services provided by PwC, the Company's external auditors, is set out in note 16 to TSB Group's consolidated financial statements.

Internal Control and Governance Framework

An explanation of the Bank Executive Committee and its sub-committees is set out below.

(i) Bank Executive Committee

Chaired by the Chief Executive Officer, the Bank Executive Committee is TSB Group's principal executive committee. The Bank Executive Committee collectively supports the Chief Executive Officer in developing and implementing TSB Group's strategy, monitoring business performance and agreeing any actions that are required to manage issues that affect TSB Group. Consideration is given to the interests of all stakeholders, including customers, the shareholder and Partners.

All members of the Bank Executive Committee, with the exception of the Treasurer, report to the Chief Executive Officer. The Treasurer reports to the Chief Financial Officer. In addition, the Chief Risk Officer has a reporting line to the Chair of the Board Risk Committee. To protect the independence of Internal Audit, the Chief Audit Officer's primary reporting line is to the Chair of the Audit Committee with a secondary reporting line to the Chief Executive Officer. The Chief Audit Officer also has a reporting line to the Group Chief Audit Officer of Sabadell.

Bank Executive Committee Sub-Committees

(i) Asset and Liability Committee

Chaired by the Chief Financial Officer, the Asset and Liability Committee is responsible for the strategic management of TSB Group's balance sheet, the profit and loss implications of balance sheet management actions and the risk management framework for market risk, liquidity risk, capital risk, earnings volatility and economic value.

(ii) Credit Risk Committee

Chaired by the Chief Risk Officer, the Credit Risk Committee is responsible for the coordination and aggregation of all credit risk management activity, management of TSB's credit risk profile, including credit risk appetite metrics and credit strategies, and TSB's compliance with all relevant credit regulation and legislation.

How the business is managed (continued)

(iii) Operational Risk Committee
Chaired by the Chief Operating Officer, the Operational Risk Committee is responsible for identifying, assessing, managing and reporting of operational risks and the aggregation and coordination of operational risk management across the Bank, monitoring and challenging the operational risk profile, including key operational risks and controls, and for ensuring appropriate escalation and visibility of relevant breaches, losses and events.

(iv) Conduct Risk Committee
Chaired by the Distribution Director, the Conduct Risk Committee is responsible for identifying, assessing, managing and reporting conduct risk and for ensuring the delivery of substantially fair customer outcomes, that the Bank is compliant with all relevant conduct regulation and legislation, that there are no systemic conduct failings in any area, monitoring and challenging the conduct risk profile, including key conduct risks and controls, and for ensuring appropriate escalation and visibility of relevant breaches, losses and events.

(v) Model Governance Committee
Chaired by the Chief Risk Officer, the Model Governance Committee is responsible for ensuring the development, implementation and effectiveness of the model governance framework (embracing policies, methodologies, systems, processes, procedures and people), the clear articulation of the extent and type of model risk to which TSB Group is exposed, acting as the Designated Committee as required by the Capital Requirements Regulation and approving, monitoring and reviewing TSB Group's material risk models as defined by policy. This is the Board's designated model governance committee and the Chief Financial Officer is the designated Board member attending.

(vi) Product Pricing Committee
Chaired by the Products Director, the Product Pricing Committee is responsible for reviewing and approving pricing strategy and any decisions in relation to the pricing of TSB Group's products. The Product Pricing Committee provides oversight over the management of the relevant categories of risk, including conduct risk, associated with product pricing strategies.

(vii) Executive Product and Sales Process Governance Committee
Chaired by the Products Director, the Executive Product and Sales Process Governance Committee is responsible for approving changes to products and sales processes, through six key stages of the product lifecycle. The Committee provides strategic and senior oversight to identify, measure, mitigate and monitor risks associated with product design and sales processes.

(viii) Spend Wise Committee
Chaired by the Chief Operating Officer, the Spend Wise Committee is responsible for TSB Group's expenditure. The Spend Wise Committee aims to ensure that TSB Group spends efficiently and reviews cost budgets and forecasts to ensure that they support the delivery of TSB Group's strategy. The Spend Wise Committee also considers requests for expenditure that are outside of forecast and budgets before they are spent, together with a review of budgeted expenditure over a set limit to ensure such requests represent value for money.

(ix) Disclosure Committee
Chaired by the Chief Financial Officer, the Disclosure Committee is responsible for identifying inside information and determining how and when TSB Group should disclose that information in accordance with its obligations to the Sabadell Group and holders of TSB Group's listed debt.

By order of the Board

Lorna Curry
Company Secretary,
1 February 2018

Nomination Committee report

Chairman's introduction

All the Nomination Committee members are Non-executive Directors. The Committee is authorised by the Board to keep the structure, size and composition of the Board under review and for making recommendations to the Board with regard to any changes required. It leads the process for appointments to the Board, Board committees and the chairmanship of those committees and also considers succession planning for the Board, taking into account the skills and expertise that will be needed in the future. The members of the Nomination Committee are Will Samuel (Chairman), Dame Sandra Dawson, Richard Meddings (appointed to the Committee on 18 October 2017), and Miquel Montes. The Nomination Committee met six times during the year.

Recruitment of Directors

The Committee met on several occasions during the course of 2017 to discuss the composition of the Board and, in particular, the need to enhance the Board's collective experience in retail banking/financial services, SME banking and digital transformation. Following an extensive search supported by Korn Ferry (who have no other connection with TSB Group), the Committee considered and recommended to the Board the appointment of Paulina Beato as an Independent Non-executive Director. Paulina was appointed as a Director of TSB on 22 March 2017. Subsequently, and following further searches supported by Korn Ferry, the Committee considered and recommended to the Board the appointments of Richard Meddings and Dr Stephen Page as Independent Non-executive Directors. Richard and Stephen were appointed as Directors of TSB on 20 September 2017. Subsequent to this, the Committee considered and recommended to the Board that Paulina be appointed as a member of the Remuneration and Risk Committees of the Board, Stephen as a member of the Risk Committee of the Board and Richard as a member of the Nomination Committee of the Board. These recommendations were approved by the Board on 18 October 2017, taking effect immediately. As at the end of the year, the Nomination Committee and the Board acknowledge that there remains a need to further strengthen the Board's collective experience in SME banking and the search for suitable candidates in this regard continues, supported by Korn Ferry.

Extension of Term of Office of Directors

Given the Board changes envisaged by the searches outlined above, the Committee considered the need to extend the tenure of the cohort of Non-executive Directors appointed at the time of the Bank's IPO in 2014, in order to enable a smooth transition in the composition of the Board. Accordingly, early in 2017, the Committee recommended to the Board that the term of office of Will Samuel (as Chairman and Non-executive Director), Dame Sandra Dawson, Sandy Kinney and Polly Williams (as Non-executive Directors) be extended, for differing lengths of time, with effect from the date of expiration of each Director's existing term of office. This recommendation was endorsed by the Board at its meeting held on 22 February 2017.

Diversity

TSB is committed to fair and consistent treatment of all Partners regardless of their personal characteristics, which include gender, ethnicity, religion, sexual orientation, transgender status, disability, nationality or age, as further detailed in the Partners' report starting on page 43. The Board has adopted this approach to diversity and had regard to it during the recruitment process for the new Independent Non-executive Directors discussed above. The Board diversity policy promotes and affirms TSB Group's aspiration to meet and exceed the target of 33% of Board positions being held by women, as set out in the Hampton-Alexander Review. Currently 33% of members of the Board are women. Additionally, three of the four Board Committees are chaired by women. In identifying candidates for future appointments, the Committee will consider the balance of skills, knowledge, experience and diversity required on the Board for a particular appointment. The percentage of women in senior management positions is set out on page 44.

Board Chairman

Towards the end of 2017, I indicated my intention to stand down as a Director and the Chairman of the TSB Boards following four years in the role. The Committee considered a number of candidates for the role of Chairman and, ultimately, recommended to the Board that Richard Meddings be appointed, which was endorsed by the Board and, subsequently, received regulatory approval. I will retire from the TSB Boards and Richard will assume the role of Chairman immediately following the completion of the 2017 Annual Report and Accounts. I wish Richard every success in this position as he steers the Board through the next phase of TSB's development.

Nomination Committee report (continued)

The Chairman's other significant interests

Since 1 January 2017, I have undertaken the role of Chairman and Non-executive Director of Tilney Group Limited, where I also chair the Remuneration and Nomination Committees. Since 7 December 2017, I have undertaken the role of Non-executive Director and Chairman Designate of John Laing Group plc. I have no other significant commitments.

Will Samuel

Chairman,

1 February 2018

Audit Committee report

Chair's introduction

Running the bank in a transparent and straightforward manner is central to TSB's local banking business model. These values apply equally to the Audit Committee and it is a reflection of this transparency, and the importance placed on the role of the Committee, that a report on its activities is included in this Annual Report on a voluntary basis. I will ensure that I and the Committee are held to account and that its activities continue to be reported in a transparent and straightforward manner.

I am a chartered accountant and spent a number of years as an Audit Partner at KPMG. As well as my TSB Board role, I am a Non-executive Director of Jupiter Fund Management plc, RBC Europe Limited and XP Power Ltd.

I have been chair of the Committee throughout 2017 and have been ably supported by my fellow Non-executive Directors, Graeme Hardie, Sandy Kinney and Tomás Varela, who have served as members of the Committee throughout the year. Biographies of the members of the Committee can be found on pages 53 to 57. All Non-executive Directors, including the Chairman, of TSB Group have a standing invitation to attend meetings of the Committee.

The report that follows describes the Committee's responsibilities and its activities during 2017. As a result of the strategic importance of the IT Migration Programme, the Committee allocated a considerable amount of its time to oversight and challenge the management of the risks associated with this Programme (as detailed on page 10) and accordingly increased the frequency of Committee meetings by holding 11 meetings in 2017. The report also describes the matters reviewed by the Committee in assessing the transparency and integrity of TSB Group's financial reporting, explains the Committee's work in assessing the effectiveness of TSB Group's risk management and internal control systems and the activities undertaken to monitor the work and priorities of the Internal Audit function.

In discharging its responsibilities during 2017, the Committee has sought to develop a transparent and open framework of review and challenge of management's key financial reporting estimates and judgements. External audit provides a key role in this challenge process and the Committee has satisfied itself as to the effectiveness and independence of the external auditors during 2017.

As outlined in my report in the 2016 Annual Report and Accounts, the Committee has taken particular interest in the following matters during 2017:

- maintaining an effective control framework during a period of rapid growth and when management are preparing for the migration to the new platform provided by Sabadell;
- understanding the consequences for TSB Group's control framework resulting from the IT Migration Programme; and
- overseeing TSB Group's readiness for IFRS 9 *'Financial Instruments.'* In particular, requesting 'deep dives' of management's approach to compliance with the new financial asset impairment and classification requirements, testing the sensitivity of impairment provisions to key management judgements, and debating and challenging management's conclusions in the context of industry benchmarking.

I expect the Committee's focus to evolve during 2018 to overseeing TSB Group's readiness for the final stage of the IT Migration Programme. With TSB Group having made the initial transition to IFRS 9, the Committee will oversee the maintenance of an effective post implementation control framework.

Polly Williams
Chair, Audit Committee,
1 February 2018

Audit Committee report (continued)

Membership and operation of the Committee

The Committee currently comprises three Independent Non-executive Directors (Polly Williams, Sandy Kinney and Graeme Hardie) and one Non-executive Director (Tomás Varela), each with recent, relevant experience in finance or banking. All members of the Committee are also currently members of the Board Risk Committee.

Committee meetings are attended by members of the Bank Executive Committee including the Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Chief Audit Officer, and General Counsel. The external auditor, PwC, attend each meeting of the Committee which includes a private session with the Non-executive Directors, without the presence of Bank Executive Committee members, other than the Chief Audit Officer.

I report to the Board after each Committee meeting on the main matters discussed so that all Directors are informed on the activity of the Committee. I am available to all Directors for discussion of any matters in more detail and maintain regular dialogue outside Committee meetings with the Bank Executive Committee members, particularly the Chief Executive Officer, Chief Financial Officer, Chief Operating Officer and Chief Audit Officer, and also with the lead and engagement partners of the external auditor.

The Committee met 11 times during 2017. This was an increase from previous years, enabling the Committee to provide regular oversight, on behalf of the Board, of the management of the risks associated with the IT Migration Programme and the implementation of IFRS 9 '*Financial Instruments*'.

Audit Committee responsibilities and activity in 2017

The Committee is responsible for ensuring that a straightforward and transparent culture exists to ensure that TSB Group operates within the Board approved risk appetite for financial reporting, internal control and whistleblowing. Specifically, the Audit Committee is responsible for reviewing and reporting to the Board on:

- Financial statements and related financial reporting;
- Risk management and internal control systems;
- Risks associated with TSB's IT Migration Programme.
- Adequacy of whistleblowing arrangements;
- Performance and effectiveness of the Internal Audit function;
- Effectiveness of the relationship with the external auditor; and

Financial statements and related financial reporting

The Committee is responsible for review and challenge of TSB Group's interim results announcements and annual financial statements, including the significant financial reporting estimates and judgements which they contain. During 2017, the Committee has considered the following matters:

(i) The consistency and appropriateness of, and any changes to, significant accounting policies

The Committee has considered and accepted management's review of TSB Group's accounting policies which remain unchanged from those adopted in 2016. The Committee has also received reports from management on TSB Group's readiness to comply with IFRS 9 '*Financial Instruments*' and IFRS 15 *'Revenue from contracts with customers'* which came in to force with effect from 1 January 2018. In respect of IFRS 9, the Committee requested that management prepare a number of 'deep-dive' reviews on key areas of management judgement, the approach to credit modelling and the related control framework. This is reported in more detail on page 37. The Committee has also reviewed the appropriateness of the disclosures in the consolidated financial statements on pages 60 to 112 in relation to TSB Group's IFRS 9 accounting policies and the transitional impact of adopting both IFRS 9 and IFRS 15 at 1 January 2018.

(ii) The methods used to account for significant transactions

The Committee has reviewed and supported proposals from management on the accounting for the issuance of covered bonds, the return of the Mortgage Enhancement portfolio to LBG, and the planned transfer to a new debit card provider.

(iii) Viability and going concern assessments

The Committee has considered management's approach to, and the conclusions of, the assessment of TSB Group's ability to remain a going concern. The Committee considered and, after taking external market developments into account, supported management's conclusion that it remained appropriate to adopt the going concern basis in preparing the consolidated financial statements. The Committee also considered management's approach to, and the conclusions of, the assessment of TSB viability. In particular the Committee considered and supported the approach adopted by management in determining the period over which viability was assessed. The results of the viability assessment are set out on page 14.

Audit Committee report (continued)

(iv) Review of annual report – fair, balanced and understandable

The Committee considered management's approach to, and governance arrangements over, the preparation of this annual report and recommended to the Board that, taken as a whole, it was considered to be fair, balanced and understandable. The approach and results of the assessment are set out in the Directors' report (page 42).

(v) Whether TSB Group has made appropriate estimates and judgements

The Committee has reviewed the nature, basis for and the appropriateness of the estimates and judgements proposed by management in the financial statements. The table below summarises the position reflected in TSB Group's financial statements for the year ended 31 December 2017. After challenge, the Committee supported management's proposals.

Significant accounting estimates and judgements	**Audit Committee considerations**	**Financial statement reference**
Impairment provisioning (IAS 39)	At 31 December 2017, TSB Group's allowance for impairment losses was £71.6 million. Determining the adequacy of provisions against the loan portfolio requires judgement in assessing the level of incurred losses in the loan portfolio and future cash flows expected from impaired loans. During 2017, the Committee reviewed regular reports from management on provisioning including management's adjustments to modelled outcomes. These reports assessed the adequacy of historic provisions against subsequent recoveries, reviewed management's governance arrangements over provisioning adequacy and in particular the governance over impairment models and benchmarked TSB Group's metrics against other banks. At 31 December 2017, the impairment provisions included £22.8 million of management's adjustments to modelled outcomes. A key focus of the Committee during the year was an assessment of the level and rationale for such adjustments. The Committee challenged reports prepared by management to support these adjustments, and management's plans to amend, where appropriate, the relevant models to minimise future adjustments. The Committee concluded that a robust governance framework existed to monitor provisioning adequacy and that the assumptions and judgements applied by management were appropriate.	Note 10 (page 76)
IFRS 9 '*Financial Instruments*'	The adoption of IFRS 9 at 1 January 2018 will have a material impact on the allowance for loan losses. The application of the accounting policies and expected credit loss measurement methodologies outlined on page 80 resulted in an expected increase in the allowance for loans losses of £96 million, with a corresponding increase in deferred tax assets of £24 million, leading to a net decrease in shareholder's equity of £72 million at 1 January 2018. The application of the classification and measurement requirements is not expected to result in any material changes to the measurement basis of TSB Group's financial assets. During 2017, the Board and the Committee requested that management hold a number of 'deep-dive' reviews on TSB Group's approach to IFRS 9. These deep-dives outlined proposals for the modelling and IT control framework and key areas of management judgement. These included management's approach to the application of multiple economic scenarios and associated probability weightings in measuring expected credit losses and the setting of thresholds for assessing when a loan moves from stage 1 to stage 2 when the required loss allowance is increased from a 12 month expected loss to a lifetime expected loss. The Committee challenged management to provide analysis of the sensitivity of the allowance for loan losses to alternative loan staging criteria and the application of alternative probability weights to the proposed macroeconomic scenarios. The Committee considered benchmark data provided by TSB Group's advisors to compare management's proposed judgements against emerging trends in the banking industry. The Committee was satisfied that the judgements applied by management in setting the adjustment to IFRS 9, in particular, the selection and probability weighting of economic scenarios and the setting of stage allocation thresholds, were appropriate.	Pages 79 to 81

Audit Committee report (continued)

(v) Whether TSB Group has made appropriate estimates and judgements (continued)

Customer remediation provision	Conduct issues remain a key focus of the banking industry. Notwithstanding the indemnity given by LBG, TSB Group retains the primary liability for alleged misconduct to its customers. At 31 December 2017, TSB Group carried provisions of £34.5 million (2016: £10.8 million), which was materially covered by a corresponding asset in respect of an indemnity provided by Lloyds Bank plc. The provisions carried are primarily in respect of alleged mis-selling of added value current accounts, alleged unfair treatment of mortgage customers in arrears, and compensation for alleged breaches of the Consumer Credit Act. The Committee reviewed reports from management setting out the approach undertaken to assess any liability for alleged conduct issues. This included assessing themes and volumes of customer complaints received by TSB Group. The Committee was satisfied that the provisions, recovery under the indemnity and related disclosures in the financial statements were appropriate.	Note 31 (page 105)
Recoverability of deferred tax assets	At 31 December 2017, TSB Group's deferred tax assets of £68.6 million primarily reflected unutilised temporary differences arising from the transfer in 2013 of customer balances to TSB Group from LBG entities. Continued recognition of this asset requires judgement in assessing the availability of future taxable profits to absorb these temporary differences. The Committee considered reports from management and concluded that sufficient taxable profits are forecast against which the full temporary difference is expected to be utilised. The Committee agreed with management's judgement that, based on TSB Group's forecast taxable profits, continued recognition in full of the deferred tax asset remained appropriate.	Note 20 (page 88)
IT Migration Programme accounting	TSB Bank plc and its ultimate parent company, Sabadell, confirmed a set of arrangements between themselves in 2016 which restricts the aggregate financial exposure of the IT Migration Programme to TSB Bank plc to a maximum of £15 million. As a consequence, TSB Group have deferred £124.5 million of IT Migration Programme costs incurred to date as a prepayment of charges for services from a Sabadell Group company that will crystallise on the completion of the IT Migration Programme. The Committee assessed a report from management setting out the approach for accounting for the IT Migration Programme in light of the underlying contractual arrangements and the carrying value of the deferred expense asset. The Committee was satisfied that the accounting treatment was appropriate.	Note 28 (page 103)
Effective interest rate methodology	At 31 December 2017, TSB Group carried an asset of £11.8 million in respect of the deferred recognition, for accounting purposes, of bonus interest payable on certain savings products. A net asset of £21.1 million was carried in respect of mortgage origination fees and income and early redemption fee income, and an asset of £31.8 million in respect of the premium paid on acquisition of the Whistletree Loans portfolio and associated deferred costs. Determining the carrying value of these assets requires management to estimate the expected repayment profile of the respective savings balances and mortgage balances. The Committee reviewed reports from management during the year summarising their approach to estimating the expected repayment profile of the portfolios. With respect to the savings portfolio this included consideration of the effect of new pricing on existing customer behaviour, developments in the industry, and an assessment of customers' future behaviour in the current low interest rate environment. The Committee was satisfied that the carrying value of the assets and the associated income recognition was appropriate.	Note 1 (page 68)

Audit Committee report (continued)

Risk management and internal control systems

The Committee is responsible for reviewing the adequacy and effectiveness of TSB Group's risk management and internal control systems and reporting on that review. As described in the review of the principal risks and uncertainties, on page 11, TSB Group has a significant dependency on LBG for the provision of banking services and the effective operation of related controls under the Long Term Services Agreement with LBG. The Committee includes these controls within the scope of its review. In undertaking that review the Committee considered the following specific matters:

- Ongoing monitoring reports on the effectiveness of TSB Group's risk management and internal control systems;
- A review which concluded that TSB Group's internal financial control framework is operating effectively;
- Regular management information on the activities of Internal Audit and its annual report on internal controls; and
- The review of matters arising from a Type 2 International Standard on Assurance Engagements (ISAE) 3402 controls report from LBG.

On the basis of this work, the Committee was satisfied that TSB Group's risk management and internal control systems operated effectively during 2017. The key elements of the management of risk within the business and the effective system for internal controls are set out within the corporate governance statement (see page 31).

Risks associated with TSB's IT Migration Programme

TSB is preparing for the transfer from the existing IT and operational services provided by LBG to one provided by companies within the Sabadell Group and other third party suppliers. The Committee has been requested by the Board to oversee the management of the Programme risks as they affect the delivery of the Programme and its objectives, and oversight the risk management and internal control systems adopted by the Programme.

The Committee met 11 times during 2017 and requested reports from management on both the progress of the Programme against a defined and pre-approved delivery plan and the management of the associated Programme risks. The Programme management team provided a number of 'deep-dive' reviews on areas that the Board and Committee had requested, such as customer journeys through migration and the end state operating model. In addition, there are robust second and third lines assurance plans in place to support the Programme. These reviews focus on both the key risks and key decision points of the Programme. These, along with third party reviews, provide additional insights to the Committee on the effectiveness of the Programme's risk management processes.

Adequacy of whistleblowing arrangements

The Committee oversees the adequacy of TSB Group's whistleblowing arrangements, ensuring that they are proportionate and enable Partners and contractors to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. During 2017, in her role as TSB's Whistleblowing Champion, the chair of the Audit Committee sought, and received, regular reports from management which provided details of whistleblowing matters. The Committee received an annual report from management providing details of whistleblowing matters and challenged management on TSB Group's plans to ensure whistleblowing policies and processes were aligned with external best practice. The Committee was satisfied that there were no material concerns raised nor breaches of policy or failure in controls relating to TSB Group's Whistleblowing processes.

Performance and effectiveness of the Internal Audit function

The Committee is responsible for monitoring the performance and effectiveness of Internal Audit. During 2017, the Committee carried out this responsibility by:

- Reviewing and approving the remit of Internal Audit, in line with the Chartered Institute of Internal Auditors' Guidance on Effective Internal Audit in the Financial Services Sector;
- Reviewing and approving the 2017 Internal Audit plans in line with TSB Group's strategy, ensuring these had appropriate coverage of the business (including the IT Migration Programme) and were flexible to enable a focus on significant risks in 2017;
- Receiving regular reports from the Chief Audit Officer on the range of Internal Audit activities undertaken in 2017 and monitoring activities resulting from Internal Audit reports;
- Approving the Internal Audit budget, including for using subject matter expertise where appropriate, to deliver the audit plan;
- Reviewing the Internal Audit annual self-assessment against industry standards;
- Reviewing the interaction between Internal Audit and the Risk function;
- Reviewing the interaction between Internal Audit and the external auditor; and
- Confirming that Internal Audit makes independent assessments of TSB Group's control framework but is fully informed by management's and the Risk function's reporting and views on risks and controls.

Audit Committee report (continued)

Effectiveness of the relationship with the external auditors

The Committee is responsible for the effectiveness of TSB Group's relationship with its external auditor and for assessing their independence and objectivity. During 2017 the Committee discharged this responsibility by:

- Agreeing the terms of the audit engagement letter and reviewing and approving the audit fee proposal. Fees paid to the external auditor are set out in note 16 to the consolidated financial statements on page 85;
- Reviewing and challenging the external auditor's audit strategy and consideration of significant and elevated audit risks to ensure TSB Group's circumstances are appropriately reflected;
- Receiving reports from the external auditor covering management's estimates and judgements;
- Reviewing the outcomes of the Financial Reporting Council's Audit Quality Review inspection reports as they relate to PwC and potential considerations for TSB Group's audit;
- Considering the approach to obtaining independent assurance over outsourced controls;
- Performing ongoing review of the audit service through discussions between the Chair of the Audit Committee, Chief Financial Officer and Chief Risk Officer and PwC colleagues; and
- Ensuring compliance with policy governing the use of the external auditor for non-audit services to safeguard their objectivity and independence (see note 16 to the consolidated financial statements on page 85 for fees paid to the external auditor).

The Committee is mindful of the requirement under EU legislation to tender TSB Group's external audit, at a minimum, every 10 years and is reviewing this requirement having regard to the wider Sabadell external audit relationship.

PwC has held the position of external auditor of TSB Bank plc since 1997 and of the Company since its incorporation, both as part of the wider historical LBG audit relationship. The Committee has taken into account the knowledge and experience that PwC has of TSB Group's business and the need to align with the broader Sabadell Group wide audit arrangements. Consequently, the Committee has recommended to the Board that the re-appointment of PwC for the audit of the 2018 financial statements is put to the shareholder along with a resolution for the Committee to set the remuneration and terms of engagement of the Company's auditor. Laura Needham was the senior statutory auditor for the audit of the 2017 financial statements.

Polly Williams
Chair, Audit Committee,
1 February 2018

Directors' report

Introduction

The Directors of TSB Banking Group plc (the Company) present their report and audited consolidated financial statements for the year ended 31 December 2017, in accordance with section 415 of the Companies Act 2006.

The information set out on pages 2 to 23 and, in particular, the following cross-referenced material, is incorporated into this Directors' report:

- The corporate governance statement (pages 24 to 58);
- Outlook – delivering through uncertainty (page 4);
- Statement of Directors' responsibilities (page 58); and
- Partners' report (pages 43 to 45).

Results and dividends

The consolidated balance sheet can be found on page 64 and the consolidated statement of comprehensive income is on page 65. The Directors do not currently propose to pay a dividend.

Directors

The Directors of the Company who were in office during the year, or from the date of their appointment, and up to the date of signing the financial statements were:

Will Samuel	
Paulina Beato	*(appointed on 22 March 2017)*
Dame Sandra Dawson	
Graeme Hardie	
Sandy Kinney	
Richard Meddings	*(appointed on 20 September 2017)*
Miquel Montes	
Stephen Page	*(appointed on 20 September 2017)*
Paul Pester	
Ralph Coates	
Tomás Varela	
Polly Williams	

The biographies of TSB Group's Directors appear on pages 53 to 57. The Company's articles of association (the Articles) give the Directors power to appoint and replace Directors. Under the terms of reference of the Nomination Committee, any appointment must be recommended by it for approval by the Board of Directors. Directors can also be appointed or removed from office by written notice provided to the Company by Sabadell as the sole shareholder.

Power of Directors

The Directors are responsible for managing the business of the Company and may exercise all the powers of the Company so long as the Articles or applicable legislation do not stipulate that any such powers must be exercised by the members.

Directors' indemnities

Each of the Directors has the benefit of a deed of indemnity which constitutes a 'qualifying third party indemnity provision'. This indemnification for Directors provided by the Company has been arranged in accordance with the Articles and the Companies Act 2006. With the exception of Paulina Beato, Richard Meddings and Stephen Page, the indemnities were in place throughout 2017. The indemnity for Paulina Beato was executed on 26 April 2017, whilst the indemnities for Richard Meddings and Stephen Page were executed on 18 October 2017. Each of the indemnities remain in force at the date of signing these financial statements and are available for inspection at the Company's registered office.

Directors' emoluments waiver

Miquel Montes and Tomás Varela do not receive a fee as Non-executive Directors of the Company. None of the other Directors, save for the Chairman who waived his entitlement to the fee for membership of the Nomination Committee, have waived their emoluments during the period under review, nor have they agreed to waive future emoluments.

Share capital

At 1 February 2018 the total issued share capital with voting rights consisted of 500,000,000 ordinary shares of £0.01 each. The total issued share capital is held by Banco de Sabadell, S.A.

Future developments

The development of TSB Group is set out in the Chief Executive Officer's statement on pages 3 to 5.

Directors' report (continued)

Employee information

The Partners' report (pages 43 to 45) is an integral part of the Directors' report providing information about TSB's Partners.

Environmental information

TSB Group is committed to being a responsible user of resources and has saved nearly 6 million kilowatt hours of energy since it was relaunched, through improvements it has put in place, such as more efficient use of technology and reductions in hardware. We continue to consider ways in which we can improve our environmental impact; for instance we reduced the use of vehicles in our business by streamlining waste collections and postal deliveries. One of the anticipated benefits of the IT Migration Programme will be a reduction of our energy usage as a result of a more efficient use of technology.

Political donations and expenditure

No amounts were given for political purposes during the year.

Financial risk management and hedging policies

Details of the use of financial instruments, together with risk management disclosures can be found in the Managing financial risk section of the financial statements on pages 90 to 100 and the Risk management section in the Strategic report on pages 8 to 14.

Post balance sheet events

There are no significant events affecting TSB Group that have arisen between 31 December 2017 and the date of this report that require disclosure.

Research and development activities

TSB Group develops new products and services during the ordinary course of business.

Overseas branches

TSB Group does not have any branches outside of the United Kingdom.

Corporate headquarters and registered office

The corporate headquarters and registered office address for TSB Banking Group plc is 20 Gresham Street, London, EC2V 7JE. Telephone: +44 (0)20 7003 9000. Website: www.tsb.co.uk.

Disclosure of information to external auditors

In accordance with the provisions of the Companies Act 2006, the Directors serving at the date of approval of this report confirm that, so far as each Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that he or she ought to have taken as a Director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Going concern

The Directors recognise their responsibility to make an assessment of TSB Group's ability to continue as a going concern, for a period of at least twelve months from the date the financial statements are approved. As set out on page 14, the Directors' assessment of going concern is integrated with that of the assessment of the viability of TSB Group. The Directors are satisfied that adequate funding and liquidity resources will be in place to allow the financial statements to continue being prepared on a going concern basis and are not aware of any material uncertainties that may cast significant doubt upon TSB Group's ability to continue as a going concern.

Fair, balanced and understandable

The Board has ultimate responsibility for reviewing and approving the annual report. In voluntarily adopting the principles of the UK Corporate Governance Code, the Directors confirm that they consider that the annual report, taken as a whole, is fair, balanced and understandable and provides the information necessary for the shareholder to assess the Company's position and performance, business model and strategy. When arriving at this conclusion the Board was assisted by a number of processes including:

- The annual report is drafted and comprehensively reviewed by appropriate senior management with overall co-ordination by the Financial Controller;
- A verification process is undertaken to ensure factual accuracy, with third party review by legal advisers; and
- The annual report is reviewed by TSB Partners from a range of functions, TSB's Bank Executive Committee and the Audit Committee prior to consideration by the Board.

By order of the Board

Lorna Curry
Company Secretary, 1 February 2018
Registered in England and Wales, Company Number 08871766

Partners' report

We are proud of the collaborative and engaging culture we have in TSB. This is achieved by listening to and acting on feedback from Partners. Overall Partner engagement increased in 2017 and our culture continues to grow positively, evidenced by the Partner Experience Survey, Partners' interest in internal communications articles and Partner calls regarding new IT, migration updates, customer journeys and wider community engagement. In early 2017 TSB was recognised as the only bank to appear in the *'Best Companies'* listing and is one of only four UK companies to be recognised in both the '*Great Place to Work'* and *'Best Companies'* lists. In addition, we continue to work closely with our recognised unions, Accord and Unite, to build strong relationships and with whom membership is growing steadily.

Encouraging Partner collaboration and feedback

Collaboration and two way communication is encouraged at all levels and is key to TSB's strategy. Paul Pester holds a fortnightly 'stand up' where he can communicate directly with Partners. This approach is repeated by Executives across TSB. 'The Link', a forum formed of Partners across all levels, gathers and builds on Partner feedback and enables meaningful dialogue between Partners and the executive leadership. There are five regional groups covering Britain, made up of Partners from every part of the business. The outputs from every meeting are presented to the Bank Executive Committee to help inform TSB's strategic direction.

Partner feedback is encouraged in a number of ways, including our annual Partner Experience Survey, where Partners are asked for their opinions on working at TSB. In 2017, we continued to partner with '*Great Place to Work*', an independent global research and training consultancy that helps organisations create and sustain great workplaces. We received feedback from 73% of our Partners, our highest response rate to date. Our overall '*Great Place to Work*' trust index score was 76%, an increase of 3% from the 2016 results. This score is 6% above the minimum threshold score required to be accredited as a '*Best Workplace'* and 21% above the UK national average. In respect of 15 TSB specific questions included in the survey since TSB was relaunched in 2013, our Partners provided a result of 81%, up by 3% from last year. TSB also continued to partner with '*Best Companies'* again in 2017 and the outcome of that survey will be available later in 2018.

A number of commitments were made as a result of Partner feedback from the 2016 Partner Experience Survey, including exploring ways to better support Partner wellbeing. An 'agile squad' of Partners from across TSB was established to develop and implement initiatives to support wellbeing. This included increasing visibility and engagement with existing services, as well as introducing new activities to support the wellbeing of Partners. Existing services include our Employee Assistance Programme, which gives all Partners free access to confidential counselling and professional advice, and an Occupational Health service which allows line managers to refer Partners for medical assessments and to ensure support is available to facilitate Partner recovery.

To demonstrate and champion commitment to Partner wellbeing at the very top of the organisation, we appointed our Chief Risk Officer, Iain Laing, as executive sponsor and set up a network of Wellbeing Ambassadors across TSB who support the delivery of our wellbeing programmes. In addition, we have distributed a Wellbeing Guide to provide all Partners with useful information, tips, advice and sources of support relating to all aspects of wellbeing. As a result of our focus on wellbeing over the past 12 months, we have seen a 5% improvement in how Partners feel about wellbeing at TSB from the 2016 results.

Diversity and inclusion

Diversity and Inclusion is a significant contributor to TSB's culture. TSB achieves this through its industry-leading diversity network, Inclusion. This aims to help every Partner achieve their potential, focusing on three key themes: personal progression, work-life balance and an inclusive culture. There is executive sponsorship of each of the key audiences of disability (Rachel Lock, HR Director), gender (Helen Rose, Chief Operating Officer), ethnic diversity (Jatin Patel, Products Director) and Lesbian, Gay, Bisexual and Transgender (Peter Markey, Marketing Director).

Our Partners with disabilities are treated fairly and can compete on equal terms for career progression. TSB's Partners with Disabilities policy is designed to inform Partners of the support available to those with disabilities (including Partners who develop disabilities) and how to access this support. TSB is a level 2 Disability Confident employer, a scheme that sees TSB commit to offer an interview to disabled people who meet the minimum criteria for a job in terms of the skills needed, thereby giving them the opportunity to present their skills face to face. TSB is also a member of the Business Disability Forum.

Another key area of focus of our Diversity and Inclusion approach is Race. TSB has been included in the first annual *'Best Employers for Race'* listing and will continue to build upon this external recognition to ensure every Partner, regardless of their background, race, ethnicity or gender has the opportunity to thrive.

Partners' report (continued)

Gender balance

The culture we have built and the initiatives we have undertaken continue to improve our gender balance. We are proud of the progress we have made in this area, with 39% of women in senior manager roles, and above, in December 2017. Women comprise 21% of our Bank Executive Committee, against an industry average of 14% and comprise 33% of our combined population of Bank Executive Committee members and their direct reports (in line with the 33% target set by the Hampton-Alexander Review).

Helen Rose, TSB's gender sponsor, regularly speaks externally to share TSB's gender story. In particular, TSB was one of the first financial services companies to publish its gender pay gap in our *'Gender Balance Matters'* report, which highlights where we believe the industry could do more to improve gender diversity and highlights our signature actions to promote gender balance. At 31%, TSB's gender pay gap is a reflection of the structure of its workforce - just one percentage point of our overall gap relates to the difference in pay between men and women within the same grade. The rest is driven by the shape of our workforce and the number of women working flexibly in our customer facing roles. In continuing to promote our gender balance we will not artificially seek to reduce our gender pay gap in an attempt to equalise the balance of men and women. We will continue to recruit the best person for the job regardless of age, gender, ethnicity or background and place emphasis on our flexible working opportunities and our passion for diversity. Therefore, TSB has published three signature actions we believe will help to tackle gender balance head on and help us close the gap even more:

- We are taking steps to get more women into financial services and, more specifically, TSB;
- We will do more to support gender balanced progression at TSB; and
- We will talk about gender balance in a transparent way.

We have received positive feedback for publishing our gender pay gap figures earlier than the deadline and remain one of the first and few banks to have done so. We have called on businesses to take three simple steps to understand, take action and report back on progress towards creating gender balance:

- Businesses must come clean on the reasons for their gender pay gap;
- Businesses must act to address the causes of their gender pay gaps; and
- Businesses must be held to account on the progress they are making.

Training and development

To ensure that our culture and business strategies are aligned with our core values, we provide a range of training such as the TSB Experience, a transformational programme for all Partners which focuses on how they behave with customers and each other. Every Partner is also encouraged to have a personal development plan which they review regularly with their line manager. All Partners who are new to TSB are given an induction, Welcome to TSB and our values form a key part of such induction. The TSB Academy guides Partners through all of the learning and development that is available, and a mentoring scheme encourages informal learning at all levels of experience. Our managers have extra responsibilities that involve managing people, so we give them special training, including sessions on Dignity and Respect at Work and Unconscious Bias.

Social responsibility

In terms of social responsibility, we are proud to be part of the community in hundreds of towns and cities across Britain. For instance, each bank branch and head office site chooses a local project or charity to support. Through TSB local volunteering, we encourage every Partner to spend at least eight hours each year supporting a local good cause with time and/or skills. We make it as easy, accessible and flexible as possible, so each of our Partners has the opportunity to take part, no matter what their job or location. Since moving to a local model, we have seen fundraising by Partners of over £500k each year for our charity partners.

Recognition and reward

Not only do we give a voice to our Partners, but we also encourage the recognition and celebration of their contribution. This is demonstrated in the Say Thank You scheme which gives Partners the opportunity to recognise the contribution of fellow Partners who demonstrate TSB's values. In addition, TSB has a number of partnerships in place to enhance the recognition of its Partners. For example, TSB continues to develop its partnership with Pride of Britain and Pride of Sport. This partnership aligns with TSB values, in particular TSB's support for local people helping local people. Nominations for the Pride of Britain and Pride of Sport Awards were accepted in all TSB branches.

Partners' report (continued)

Recognition and reward (continued)

As part of this partnership, TSB created the Pride of Britain TSB Community Partner Award – aimed at celebrating the very special people, whether an individual or group, who have worked together in partnership as a force for good in their local community to improve the lives of people around them. TSB also created its own Pride of TSB to recognise the TSB Partners who are making a real difference through the extraordinary things they do at work or in their community. We had over a thousand nominations and 36 winners across different functions and categories, who attended the awards ceremonies.

As reflected in our Remuneration review starting on page 46, TSB's approach to reward aligns to our values and seeks to differentiate us from other banks. It is driven by our core values and supports our partnership model. We believe our approach is fair, transparent and consistent for everyone. At the heart of our approach is the TSB Award. It is a flat award across TSB Group where everyone has the opportunity to be awarded the same percentage – regardless of grade or role including the Chief Executive Officer and the rest of the executive team. This enables all Partners to be recognised for the important role they play in the success of our business. TSB is also committed to paying everyone at least the Living Wage. In August 2016 we became an accredited Living Wage employer which put us among a pioneering group of companies who go beyond the legal requirements and commit to paying both our direct employees and our suppliers who regularly work on our premises, at least the real Living Wage.

We also offer all Partners the opportunity to join our TSB Sharematch scheme giving them the chance to invest between £10 and £150 each month to buy shares in our parent company, Sabadell, without paying Income Tax or National Insurance on the purchase. TSB will match their investment with matching shares, on a one for one basis, up to a maximum value of £30 per month.

Conclusion

We are proud of our continued progress in making TSB a Great Place to Work, particularly in the areas of succession and development of our leaders, our engagement scores and the recognition we are receiving externally, namely from '*Great Place to Work*' and '*Best Companies*'. We are also proud to have created a working environment where our Partners are able to be themselves regardless of gender, ethnicity, age or background. Going forward, we will continue to focus on talent, succession and capability of our Partners.

Rachel Lock
Human Resources Director
1 February 2018

Remuneration review

At the time of our initial public offering in June 2014, TSB established a remuneration approach designed to be simple, fair and in line with our core values. This underlying principle remains integral to our reward philosophy.

Overview of TSB remuneration approach
The aim of our remuneration policy is to provide competitive remuneration aligned to the delivery of our strategic goals (providing the kind of banking experience people want and deserve, providing great banking to more people, and helping more people to borrow well). It is designed to attract and retain talented individuals, to promote TSB's values, and to generate sustainable business performance, while taking into account effective risk management and acceptable conduct.

The key elements of our reward approach are as follows:

- **Basic salary** provides core remuneration taking into account relevant market benchmarks, complexity of the role and the individual's experience and performance.
- **Market appropriate benefits,** principally pension contributions to a defined contribution scheme or, where appropriate, an equivalent cash payment; 4% of basic salary available to use in our flexible benefits offering; and an employer provided car or alternative cash allowance.
- The **TSB Award,** which provides an on-target annual short term incentive award opportunity of 10% of basic salary and applies to every Partner, from the Chief Executive Officer (CEO) to those on the front line. The 10% on-target award may increase, in an exceptional year, to a maximum award of 15% of basic salaries. In any given year the very best performers, whom we call Pioneers, may receive up to twice the on-target award. The TSB Award reflects the collective effort made by all Partners to deliver business success. Awards are made only if certain gateways, including risk, profitability and individual conduct, are satisfied and corporate performance targets are met.
- The **Sustainable Performance Award (SPA),** which is designed to support achievement of targets based on sustained business and individual performance. This award is granted annually to a limited number of senior Partners and is funded after the TSB Award is funded, if sufficient profit is made and risk management gateways have been satisfied.
- In addition, a small number of Partners were granted **Sabadell Integration Awards (SIA)** in 2017 to support the design and build of our new state-of-the-art banking platform. These awards will vest only to the extent that key migration and integration objectives are met, while ensuring underlying sustainability of the business.
- We will not exceed an **annual cap** on total variable remuneration of **one times fixed pay** (basic salary plus pension and other benefits) calculated in accordance with the Prudential Regulatory Authority's (PRA) remuneration code, other than in rare exceptional circumstances (e.g. migration and integration) as approved by the Sabadell Remuneration Committee following their acquisition of TSB.

2017 Remuneration policy review
The Remuneration Committee began a review of our remuneration policy in 2017 and approved a few minor changes:

- The TSB Award and SPA Award will be delivered 50% in cash and 50% in shares for the CEO and other senior Partners in line with minimum regulatory requirements;
- Material Risk Takers (MRT) that are not Risk Managers under EBA Guidelines on Sound Remuneration Policies (the EBA Guidelines) will have the deferral period on SPA awards reduced from five years to three years in line with minimum regulatory requirements; and
- The maximum SPA award level is increased from 100% to 125% of basic salary for the Board Executive Committee (BEC) and from 75% to 90% for other senior participants. These maximums have been increased to enable us to recognise exceptional circumstances such as demonstrable outstanding personal performance. Total variable pay will remain within the 1:1 cap given the ratio is calculated using fixed pay (i.e. basic salary plus pension and other benefits) whereas the SPA award is calculated as a percentage of basic salary only. We will also utilise the EBA Guidelines discount rate where appropriate. Should the EBA Guidelines discount rate be applied to any percentage of variable pay, we will disclose details of this in the 2018 Annual Report and Accounts in accordance with the requirements of the EBA Guidelines.

Remuneration review (continued)

Business performance in 2017

As outlined in the CEO report, we continued to invest in becoming a more agile, digital business in 2017. Our high-tech transformation has continued at pace, and we will be the first major bank in the UK to have designed and built a state-of-the-art banking platform for the digital age. The new platform is already being used to support a number of our core services, and customers are experiencing the benefits.

When we launched TSB in 2013, we set out to grow our market share of bank accounts by consistently attracting more than 6% of all new and switching bank accounts over a five year period. In 2017 we, again, exceeded our target, with 6.2% of all customers switching banks or opening a new account choosing TSB, equivalent to around 1,000 customers a day.

Customer advocacy and trust in TSB has translated into strong balance sheet growth. During 2017, customer deposit balances increased by £1.1 billion (3.9%) to £30.5 billion. This provided funding to help customers borrow well, with total loan balances increasing by £1.4 billion (4.9%) to £30.9 billion.

On a statutory basis, profit before taxation was £162.7 million, down £19.3 million compared with 2016. This was largely driven by the previously reported and expected increase of £122.0 million in outsourcing fees paid to LBG in 2017, and the recognition in 2016 of a £32.5 million non-recurring gain on the sale of our share in Visa Europe following its acquisition by Visa Inc.

These anticipated reductions in profit were largely mitigated by a £96.0 million increase in net interest income from the Franchise business, reflecting the continued success of our strategy, and an increase in profits from the Mortgage Enhancement portfolio of £15.5 million. Profits from this portfolio increased to £61.7 million in 2017 (compared with £46.2 million in 2016) and included a £49.7 million gain on its divestment.

Reward outcomes for 2017

This strong performance of the TSB core business and the progress being made with the IT Migration Programme is reflected in variable remuneration outcomes for all TSB Partners who meet their individual 2017 performance objectives. It is also reflected in the Remuneration Committee's decisions in respect of the CEO, as detailed later in this report, and other senior Partners.

The Remuneration Committee has approved a 2017 TSB Award pool of 12.5% of basic salaries, equivalent to £29.8 million and a 2017 SPA Award pool of £13.3 million (equivalent to 81.5% of the maximum award level). This means that all TSB partners, from the CEO to front line staff, who have an On Track performance rating, will receive 12.5% of their basic salary as a TSB Award. Our Pioneers - our outstanding performers - will receive up to double that.

Consideration for all TSB Partners

The Remuneration Committee's focus goes beyond executive pay. We are mindful of the relationship between pay for executives and more junior Partners, and to that end have sought to ensure consistency of pay outcomes with a salary budget of 2% across the whole of TSB.

TSB is committed to paying everyone at least the Living Wage. In August 2016 we became an accredited Living Wage employer which put us among a pioneering group of companies who go beyond what the law requires and commit to paying both our direct employees and our suppliers who regularly work on our premises, at least the real Living Wage.

The Committee also focuses on talent and succession, including oversight of senior leadership changes and receives regular updates on human factors, particularly in the context of the Integration and Migration Programme.

Gender pay gap

TSB was one of the first Financial Services companies to publish its gender pay gap in our *'Gender Balance Matters'* report, which highlights where we believe the industry could do more to improve gender diversity and highlights our signature actions to promote gender balance. Further information is provided in our Partners' report on page 44.

Remuneration review (continued)

Meeting our obligations
TSB's remuneration policy continues to meet regulatory requirements.

Following the publication of the PRA and the Financial Conduct Authority (FCA) Policy Statements in June 2015 which finalised changes to their Remuneration Codes, TSB moved to comply with new requirements on variable remuneration. The Remuneration Committee approved the necessary adjustments to the SPA and SIA while maintaining the fundamental scheme designs.

For any SPA Award in respect of the 2016 performance year and beyond, grants for PRA Senior Managers (in effect, BEC members) are deferred over seven years with pro rata release between the third and seventh year based on an annual release underpin. Any shares issued will be subject to a 12 month retention period after the point of release (increased from six months).

For MRTs other than Senior Managers, the deferral period could be three or five years, depending on the regulatory status of the Partner, with a retention period on the shares up to 12 months after the point of release.

Any outstanding unvested SIA awards for PRA Senior Managers will be paid 40% immediately upon vesting (in a mix of cash and shares) and 60% deferred over seven years, with a release schedule pro-rata over five years from the third anniversary of the grant date (also in a mix of cash and shares). Any shares issued will be subject to a 12 month retention period after the point of release.

TSB's approach to deferral of total variable remuneration for senior Partners ensures that awards are subject to deferral in a way that results in a slower release of variable remuneration than is required by the minimum regulatory requirements.

TSB has also noted and made relevant changes to its policies to reflect the PRA's required approach to buyouts for MRTs, which came into effect from 1 January 2017.

Consideration of conduct and risk
The Remuneration Committee takes risk and conduct issues very seriously. Risk profile and behaviours are a key gateway that must be satisfied for any of the incentive awards to pay out to individuals. Incentive pools and awards may be adjusted, including to zero, in the event of any material breaches. All elements of variable remuneration for MRTs are subject to malus and clawback provisions in line with regulatory requirements.

Remuneration review (continued)

TSB Remuneration policy overview
The table below summarises the key components of TSB's remuneration.

Fixed pay	TSB aims to provide market competitive fixed pay, taking account of relevant market benchmarks, the complexity of each role and the individual's performance. It includes: • Basic salary: Typically reviewed annually, but with no obligation to increase, taking account of general market movements and performance of TSB and the individual. • Pension: Participation in TSB's defined contribution scheme. Senior Partners may alternatively receive a cash allowance of equivalent value (after taking into account TSB's need to pay National Insurance on a cash payment) in lieu of a pension contribution. • Benefits: Benefits include private medical insurance (single cover), life assurance, provision of a car (or alternatively a cash car allowance) and funded participation in TSB's flexible benefits scheme. Other benefits may be provided where appropriate (e.g. relocation allowances). • Role based allowance: This is received only by the CEO to reflect the change in his role and specific duties following the acquisition of TSB by Sabadell in 2015.
TSB Award	The final level of the TSB Award pool is determined by the Remuneration Committee as follows: • Assessment as to whether profitability and risk management threshold gateways have been satisfied at a corporate level and consideration of the affordability of the proposed TSB Award spend. • Assessment of corporate performance against pre-determined Key Performance Indicators (KPIs), which include customer outcomes, financial resilience metrics and achievement of strategic business objectives to determine the overall award size and funding for the year. The pre-determined KPIs used to assist in deciding the overall award pool for 2017 were set under the following corporate priorities: • **Customer Outcomes (50% weighting)** – Targets were set relating to: o Complaints resolution; o Fair outcomes of sales; and o Net Promoter Score. • **Financial Resilience (25% weighting)** - A profit target was set. • **Strategic Delivery (25% weighting)** – Targets were set relating to: o Market share of Personal Current Account (PCA) flow; o Franchise Asset Growth; and o The status of the Migration Programme.

Remuneration review (continued)

TSB Remuneration policy overview (continued)

Sustainable Performance Award (SPA)	The final level for the SPA Award pool is determined by the Remuneration Committee as follows: • Assessment as to whether profitability and risk management threshold gateways have been satisfied at a corporate level and consideration of the affordability of the SPA grants after paying any TSB Awards. • Assessment of corporate performance against pre-determined KPIs, which include customer outcomes, financial resilience metrics and achievement of strategic business objectives, to determine the SPA pool size. The pre-determined KPIs used to assist in deciding the SPA Award pool size for 2017 were set under the same strategic priorities as for the TSB Award, detailed above. A further target was added for the SPA under the heading of Financial Resilience and related to the management of operating costs. 2017 SPA Awards will be made following the publication of TSB Group's results (i.e. in Q1 2018). Each tranche is released subject to satisfactory individual conduct and performance if the sustainable performance conditions have been met at each release date. These conditions are as follows: • Capital and Liquidity: No significant breach of Board risk appetite in the year. • Regulatory and Compliance: No material regulatory issues and a satisfactory internal control environment in the year. • Sustained financial performance: Performance against a pre-determined financial target (Cumulative Return on Equity) has been achieved. The testing of the metrics will determine, subject to the Remuneration Committee's discretion, the extent to which a tranche is released. The award amounts may be reduced, ultimately to zero, depending on the testing outcome and Remuneration Committee discretion.
Sabadell Integration Award (SIA)	For the SIAs granted in 2017, awards will vest dependent upon TSB Group achieving its management profit and operating cost targets for 2017 and the Remuneration Committee being satisfied that the delivery of the Migration Programme has progressed to plan. Once vested, for most participants, a portion of the award is delivered immediately and the balance is deferred. Testing of the corporate objectives ensures individual objectives have not been met at the expense of TSB Group's sustainable financial performance. The Remuneration Committee ensures any payments under the SIA are affordable. At an individual level, personal objectives were set relating to key Migration Programme targets.

Remuneration review (continued)

Highest paid Director – 2017 remuneration disclosure(*)
The table below sets out 2016 and 2017 total remuneration for TSB Group's CEO, Paul Pester, the highest paid Director.

The Remuneration Committee recognises there has been a large decrease in the CEO's total remuneration package for 2017 compared with 2016. This decrease is driven primarily by the fact that the Remuneration Committee has deferred the decision regarding release of the 2015 SIA award (50%) and the 2017 SIA award (100%) until migration and integration have been successfully completed in 2018. Any release of these awards will therefore be reflected in future disclosures.

CEO Remuneration	2017 £	2016 £ (1)
Basic salary(2)	**913,500**	900,000
Role based allowance(3)	**200,000**	200,000
Benefits(4)	**45,574**	45,500
Pension(5)	**160,545**	167,267
Fixed Pay	**1,319,619**	1,312,767
TSB Award	**114,750**	112,500
2014 SPA – Release of Tranches 2 (2016) and 3 (2017)(6)	**142,916**	131,021
2015 SPA – Release of Tranche 1 (2016) and 2 (2017)(6)	**176,192**	161,413
2015 SIA Partial Release(6)(7)	**–**	400,000
2016 SIA(7)	**–**	1,600,000
Variable Remuneration	**433,858**	2,404,934
Total Remuneration (audited)	**1,753,477**	3,717,701

Notes

(1) 2016 figures represent relevant remuneration for the full year as stated in TSB's 2016 Remuneration review updated to take account of the actual release value of the 2016 TSB Award, Tranche 2 of the 2014 SPA and Tranche 1 of the 2015 SPA, and the 2015 SIA partial release and 2016 SIA as explained at note (6) below.
(2) The basic salary for 1 January to 31 December 2017 was £913,500, last changed with effect from 1 April 2017.
(3) The role based allowance for 1 January to 31 December 2017 was £200,000, as set from 1 July 2015.
(4) Benefits include the taxable value of all benefits received, which included a car allowance and a flexible benefits allowance set annually at 4% of basic salary.
(5) Pension represents the value of the pension allowance provided, which has been paid as cash.
(6) The values shown in respect of the 2014 and 2015 SPA grants and the 2015 and 2016 SIA grants represent, in turn:
  a. The value at release of the second tranche of the 2014 SPA grant and the first tranche of the 2015 SPA grant for the performance period 1 January – 31 December 2016 (2016 column).
  b. The release of the third tranche of the 2014 SPA grant for the performance period 1 January – 31 December 2017 (2017 column). 100% of this tranche of the award was approved for release after the testing of the performance conditions.
  c. The release of the second tranche of the 2015 SPA grant for the performance period 1 January – 31 December 2017 (2017 column). 100% of this tranche of the award was approved for release after the testing of the performance conditions.
  d. The value at release of the 2015 SIA partial release and the 2016 SIA for the performance period January – December 2016 (2016 column)

  The award values at (a) and (d) shown in the table are the actual values of the awards at release on 9 March 2017. The release values differ from those shown in the 2016 Remuneration review because its publication pre-dated the release date and the value of the share element therefore had to be estimated. Relevant variable and total remuneration figures for 2016 have been adjusted accordingly.

  Release of the awards at (b) and (c) will take place on or around 9 March 2018. Since these awards are partially in Sabadell shares and the future Sabadell share price is not known the value shown has been estimated using the three day average of the Sabadell share price and Euro/Sterling exchange rate as at 31 December 2017. These awards were made in a mix of cash and shares, with the cash portion of the award at (b) being £37,800 and of the award at (c) being £45,600.
(7) 50% of the 2015 SIA award and 100% of the 2017 SIA were due to be tested at the end of December 2017 for achievement of the performance conditions. However, the Remuneration Committee has deferred the decision regarding the release until migration and integration have been successfully completed in 2018.
(8) Paul Pester was awarded a 2016 SPA grant in a mix of cash and shares, with the cash portion being £243,000 and the Sabadell share element being 433,950 shares. This award remains subject to performance conditions and will be released only to the extent that they are met. Any amounts that are released will be disclosed at the appropriate point in future reports.
(9) Paul Pester exercised share options and received shares under long term incentive schemes in 2017, as was the case in 2016.

(*) The aggregate remuneration for all Directors is set out in Note 17 to the financial statements on page 85.

Remuneration review (continued)

Consideration by the Directors of matters relating to Directors' remuneration

The Remuneration Committee is authorised by the Board to consider and recommend to the Board the framework of the remuneration policy of TSB. Policy is considered regularly by the Remuneration Committee, taking account of changes in regulation and the wider market. In formulating and reviewing policy, independent advice is sought and considered. In particular, the sustainability of the policies and their risk impact are carefully reviewed. TSB's remuneration policy is formally reviewed at least annually and, once approved by the Remuneration Committee, is reviewed and approved by the Board. The effectiveness of the remuneration policy and its application are reviewed formally by the Risk function annually. The Remuneration Committee considers the Risk function's report following that review and monitors any recommended actions.

The Remuneration Committee's full terms of reference are kept under regular review. These can be found on our corporate website at http://www.tsb.co.uk/investors/people/.

The Board Remuneration Committee is chaired by Dame Sandra Dawson and the other committee members are Polly Williams, who also chairs the Board Audit Committee, Miquel Montes and Paulina Beato. Sandy Kinney, Chair of the Board Risk Committee, attends meetings of the Remuneration Committee from time to time to ensure alignment between the work of the Remuneration Committee and the Risk Committee. Remuneration Committee meetings are also attended by the Company Chairman, the CEO, the CFO, the HR Director, the CRO, and the Director of Performance and Reward to provide input on their specialist areas. The Company Secretary acts as the secretary to the Remuneration Committee. None of these additional attendees participates in the discussion of issues directly affecting their own remuneration.

The Remuneration Committee appointed Deloitte LLP (Deloitte) to provide independent advice on remuneration matters following a presentation to the Remuneration Committee members in 2014. The Remuneration Committee reviewed Deloitte's work during 2017 and decided to continue with Deloitte's appointment. Deloitte is a member of the Remuneration Consultants Group and, as such, voluntarily operates under the code of conduct in relation to executive remuneration consulting in the UK. Deloitte has provided independent advice on matters under consideration by the Remuneration Committee including compliance with regulations, advice on market trends and data, remuneration policy and implementation of remuneration arrangements. The Remuneration Committee is satisfied that the advice it has received has been objective and independent.

Deloitte also provided advice on share plans, wider remuneration matters, taxation and financial matters and other miscellaneous consulting and assurance services. In addition, management received external advice, including market data and legal counsel, from a number of other providers which is not considered to be material in assisting the Remuneration Committee to consider Directors' remuneration.

Directors' biographies

Will Samuel
Chairman

Skills and background
Will was appointed as Non-executive Chairman on 7 March 2014. Having worked over 35 years in merchant banking and corporate finance, he brings a wealth of expertise of the banking sector and regulatory environment to his role as Chairman of TSB.

Will began his career at Coopers & Lybrand where he qualified as a Chartered Accountant. In 1977, Will joined Schroders in the Investment Management Division and worked in a variety of roles. In 1986, he was appointed a Director of Schroders plc as the Group Managing Director of Investment Banking. Schroders subsequently sold its investment banking business to become Schroder Salomon Smith Barney (SSSB) in 2000 and Will served as Co-Chief Executive Officer at SSSB until 2003, when he was appointed Vice Chairman, European Investment Bank of Citigroup Inc.

Will joined Lazard & Co in 2004 as Vice Chairman and was appointed a Senior Advisor from 2011. In January 2012, Will was appointed Senior Advisor to the Financial Services Authority and, subsequently, Senior Advisor to the Prudential Regulation Authority, stepping down prior to his appointment as Non-executive Chairman of TSB.

Will has held other Non-executive Directorships including Chairman of Howdens Joinery Group (formerly MFI Furniture Group), Chairman of Ecclesiastical Insurance Group, Chairman of H P Bulmer plc, Deputy Chairman of Inchcape plc, and Non-executive Director of the Edinburgh Investment Trust plc. Will was Trustee and Honorary Treasurer of International Alert, a charitable peace building non-governmental organisation, from 2009 to 2014.

Will is a Fellow of the Institute of Chartered Accountants in England and Wales and has a First Class Honours Degree in Chemistry from Durham University and a Degree in Mathematics from the Open University.

Current external appointments
Chairman, Non-executive Director and Chairman of the Remuneration and Nomination Committees, Tilney Group Limited
Non-executive Director and Chairman Designate, John Laing Group plc

Committee membership
Nomination Committee (Chair)

Professor Dame Sandra Dawson
Senior Independent Non-executive Director

Skills and background
Dame Sandra joined the Board on 16 May 2014. She brings a wealth of experience and knowledge gained through a broad range of activities including research, education and financial services in commercial, public and charitable bodies. Former Non-executive Directorships include Barclays Bank plc, JP Morgan Fleming Claverhouse Investment Trust plc, the Financial Services Authority, Oxfam and Winton Capital Group.

Dame Sandra was KPMG Professor of Management Studies at Cambridge Judge Business School from 1995 to 2013, Director of the School from 1995 to 2006 and Master of Sidney Sussex College Cambridge from 1999 to 2009. She was previously at Imperial College, University of London ultimately as Professor of Organisational Behaviour.

Current external appointments
- Trustee/Non-executive Director, Institute for Government
- Chairman of the Executive Committee and Trustee, Social Science Research Council USA
- Trustee, American University of Sharjah

Committee membership
- Remuneration Committee (Chair)
- Nomination Committee

Directors' biographies (continued)

Graeme Hardie
Independent Non-executive Director

Skills and background
Graeme was appointed to the Board on 19 October 2016. He has broad experience in the financial services sector, which includes extensive retail banking experience as well as various Non-executive Director roles. Graeme spent 27 years in various roles at Royal Bank of Scotland, ultimately working as Managing Director for Retail Banking at NatWest, where he led the post-acquisition change programme. After this, he became Executive Director of Retail Banking at Abbey National Bank, with responsibility for all retail financial services activities. He then spent four years as Senior Advisor to the CEO at the Financial Services Authority before moving to Non-executive Director roles, including membership of the Boards of Co-operative Bank and Metro Bank.

Committee membership
- Audit Committee
- Risk Committee

Alexandra Kinney Pritchard (Sandy Kinney)
Independent Non-executive Director

Skills and background
Sandy was appointed to the Board on 16 May 2014. She has had a distinguished career across the financial services industry. Sandy is an accountant and was previously a senior partner at PricewaterhouseCoopers LLP. She has held a number of Non-executive Directorship roles, including at Irish Life and Permanent TSB, Skipton Building Society, the FSCS and MBNA Ltd.

Current external appointments
- Non-executive Director and Chair of the Audit Committee, Credit Suisse (UK) Limited

Committee membership
- Risk Committee (Chair)
- Audit Committee

Polly Williams
Independent Non-executive Director

Skills and background
Polly was appointed to the Board on 16 May 2014. She is a chartered accountant and a former partner at KPMG LLP. She resigned from her partnership in 2003 and since then has held a number of Non-executive Directorship roles, including at Worldspreads Group plc, APS Financial Limited, Z Group plc, National Counties Building Society (as Chairman), Scotiabank Ireland Limited and Daiwa Capital Markets Europe Ltd.

Current external appointments
- Non-executive Director, Jupiter Fund Management plc
- Non-executive Director, XP Power Ltd
- Non-executive Director, RBC Europe Limited
- Trustee of the Guide Dogs for the Blind Association

Committee membership
- Audit Committee (Chair)
- Risk Committee
- Remuneration Committee

Directors' biographies (continued)

Paulina Beato
Independent Non-executive Director

Skills and background
Paulina was appointed to the Board on 22 March 2017. She is an experienced board member and advisor with significant international expertise across a range of different industries and government agencies. She has been very active with financial regulation and was involved in the restructuring of the utilities sector in Spain. Paulina brings a diverse range of experience, including a strong knowledge of audit, risk analytics and a passion for bringing competition to markets.

Committee membership
- Risk Committee
- Remuneration Committee

Richard Meddings
Independent Non-executive Director

Skills and background
Richard was appointed to the Board on 20 September 2017. He has more than 30 years of executive experience in the financial sector in both retail and business banking. A chartered accountant, he has worked in various positions in Finance, Risk, Governance and Corporate Finance at Hill Samuel, Barclays and Credit Suisse. He was an Executive Director of Standard Chartered on the Board from 2002 to 2014 and served as Group Finance Director between 2006 and 2014.

He is currently a Non-executive Director of Her Majesty's Treasury, where he chairs the Audit Committee for HM Treasury and for the 'Whole of Government Accounts'. Richard's other Non-executive positions currently include Deutsche Bank AG, and Jardine Lloyd Thompson Group plc. He also sits on the Boards of Teach First and of ICC UK. He has in the past also served as a Non-executive Director of 3i and Legal & General. Richard studied modern history at the University of Oxford.

Current external appointments
- Non-executive Director, HM Treasury
- Non-executive Director and Chair of the Remuneration Committee, Jardine Lloyd Thompson Group plc
- Non-executive Director and Chair of the Audit Committee, Deutsche Bank AG
- Trustee, Teach First
- Non-executive Director, ICC UK
- Member of the Financial Reporting Review Panel, Financial Reporting Council

Committee membership
- Nomination Committee

Stephen Page
Independent Non-executive Director

Skills and background
Stephen was appointed to the Board on 20 September 2017. He has more than 30 years' experience across strategy, change management and technology. He is especially focused on the challenges that companies face doing business in the digital age. He was formerly the Global Managing Director for Strategic IT Effectiveness at Accenture. Here he helped large and complex businesses to deliver business value from digital investments, to transform business processes and to strengthen operational performance. He also held the global role of Commercial Director for Accenture Technology Consulting.

He is a Non-executive Director of BSI Group (British Standards Institution) and The British Library and was previously a Non-executive Director of the National Crime Agency. Stephen studied computer science and music at the University of Queensland and he holds a D.Phil. from New College, Oxford where he was a Commonwealth Scholar and a member of the Programming Research Group. He is also a professional photographer specialising in portraiture.

Current external appointments
- Non-executive Director, British Standards Institution
- Non-executive Director, The British Library
- Non-executive Director, Nominet UK

Committee membership
- Risk Committee

Directors' biographies (continued)

Miquel Montes

Non-executive Director

Skills and background

Miquel was appointed to the Board on 30 June 2015. He is General Manager and Chief Operations and Corporate Development Officer of Sabadell, which he joined in 2001. He has extensive retail banking experience having held senior positions at Deutsche Bank, Banco Atlántico and Banca Catalana in the 21 years prior to joining Sabadell.

Currently, Miquel leads Sabadell's human resources, technology, innovation, operations, organisation and efficiency functions. In addition, he is responsible for Sabadell's corporate development function and is a member of Sabadell's Executive Committee. He is an academic adviser at ESADE Business School and holds a Global Executive MBA from ESADE and an MBA from Georgetown University (McDonough School of Business - School of Foreign Services).

Current external appointments

- President of Solvia

Committee membership

- Remuneration Committee
- Nomination Committee

Tomás Varela

Non-executive Director

Skills and background

Tomás was appointed to the Board on 30 June 2015. He is General Manager and Group Chief Financial Officer of Sabadell, which he joined in 1992. Over 25 years he has developed his career at Sabadell, having previously held different managerial positions in the insurance sector at Allianz (Spain) and as an auditor at Price Waterhouse (a legacy firm of PwC) over a 10 year period.

In his current role, Tomás's responsibilities include financial reporting, asset and liability management, funding structure, economic analysis, accounting and financial management, capital management, short, medium and long term financial planning, cost management, M&A financial structure and investor relations. He is a member of Sabadell's Executive Committee.

Tomás is a Certified Public Accountant and Certified Insurance Broker. He holds a B.Sc. in Economics from the University of Barcelona and an MBA in International Business from the European University (Barcelona).

Committee membership

- Audit Committee
- Risk Committee

Directors' biographies (continued)

Paul Pester
Chief Executive Officer

Skills and background
Paul is the Chief Executive Officer of TSB Banking Group plc. Paul was appointed to lead the Verde Programme for LBG in May 2011 through which he led the design, build and launch of TSB Bank and its separation from LBG.

Paul led the successful IPO of TSB Banking Group on the London Stock Exchange in June 2014. In June 2015 TSB was acquired by the Spanish bank, Sabadell, with Paul becoming a member of Sabadell Group's Global Management Committee.

Previously, Paul had spent six years as the first Group CEO of Virgin Money, and worked at Santander and LBG. Having graduated with a doctorate in theoretical physics from the University of Oxford, Paul spent the early part of his career in management consulting, principally at McKinsey & Company.

Ralph Coates
Chief Financial Officer

Skills and background
Ralph was appointed to the Board on 1 July 2016. He qualified as a Chartered Accountant with PricewaterhouseCoopers (PwC) in South Africa, and subsequently spent four years in PwC's London office in the Transaction Services division, focusing on M&A in the retail sector.

In 2004, Ralph joined Barclays Bank in London, becoming Finance Director for the UK Retail & Business Bank in 2011.

Prior to joining TSB, Ralph was the Finance Director of the Bank of England, supporting its strategic transformation and the delivery of its policy agenda.

Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulation.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared TSB Group and Company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of TSB Group and the Company and of the profit or loss of TSB Group for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- state whether applicable IFRSs as adopted by the European Union have been followed in the TSB Group and Company financial statements, subject to any material departures disclosed and explained in the financial statements;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that TSB Group and the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain TSB Group's and the Company's transactions and disclose with reasonable accuracy at any time the financial position of TSB Group and the Company and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards TSB Group financial statements, Article 4 of the IAS Regulation. The Directors are also responsible for safeguarding the assets of the Company and TSB Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of TSB Group's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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Financial statements

Alignment with TSB Group's business model

The presentation of TSB Group's consolidated financial statements aligns with the execution of its strategy, its business model and the management of the financial risk to which it is exposed. As such, the consolidated financial statements are structured around the key elements of TSB Group's business model as explained on page 7.

Basis of preparation

These consolidated financial statements of TSB Banking Group plc (TSB Group) comprise the results of TSB Banking Group plc consolidated with those of its subsidiaries, including TSB Bank plc. Details of subsidiary undertakings are provided in note 4 to the Company financial statements on page 111. These consolidated financial statements have been prepared in accordance with the Companies Act 2006 as applicable to companies using International Financial Reporting Standards (IFRS) and with IFRS, as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS, issued by the International Accounting Standards Board (IASB) and those prefixed IAS, issued by the IASB's predecessor body, as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body. TSB Group has taken advantage of relaxations in hedge accounting requirements in the EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* adopted by the EU which are not available in the version issued by the IASB.

The consolidated financial statements have been prepared under the historical cost convention as modified by financial assets and financial liabilities, including derivative contracts at fair value through profit or loss and available-for-sale financial assets. The Directors consider that it is appropriate to continue to adopt the going concern basis in preparing the consolidated financial statements.

Accounting policies

The significant accounting policies used in the preparation of the consolidated financial statements are presented in a manner consistent with TSB Group's business model and are therefore included in the relevant sections of the consolidated financial statements. In addition, the following accounting policies relate to the consolidated financial statements taken as a whole.

Consolidation - Subsidiaries are all entities (including special purpose entities) over which TSB Group has control. TSB Group controls an entity when it is exposed to, or has rights to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Such power, generally but not exclusively, accompanies a shareholding of more than half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to TSB Group and are deconsolidated from the date that control ceases. Inter-company transactions, balances and unrealised gains and losses on transactions between TSB Group companies are eliminated.

Foreign currency translation - Foreign currency transactions are translated using the exchange rates prevailing at the date of the transaction. Monetary items denominated in foreign currencies are translated at the rate prevailing at the balance sheet date. Foreign exchange gains and losses resulting from the restatement and settlement of such transactions are recognised in other operating income/expenses in the income statement.

Segmental analysis

In previous years, performance was analysed on a segmental basis, consistent with how TSB Group was then organised, managed and reported internally. The segments reported internally were as follow:

- *Franchise:* comprising the UK retail banking business which offers a range of retail financial services including current accounts, savings products, personal loans, credit cards and mortgages.
- *Whistletree Loans:* a separate portfolio of former Northern Rock mortgages and unsecured loans which was acquired with effect from 7 December 2015 and which at 31 December 2017 had total customer loan balances of £2.1 billion.
- *Mortgage Enhancement:* a separate portfolio of mortgage assets which was assigned to TSB Group in 2014. The portfolio was returned early to LBG in June 2017, having achieved its profit target.

During 2017, the Whistletree and Franchise segments were combined, reflecting the direct nature of the relationship between TSB and Whistletree branded customers. In contrast, Mortgage Enhancement, where TSB Group had a beneficial interest in the portfolio but no customer relationship, continued to be reported as a separate segment until it was divested in June 2017.

Following the early return of the Mortgage Enhancement portfolio in June 2017, the results and performance of TSB Group are reviewed as a single segment UK banking business.

Critical accounting estimates and judgements

The preparation of financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying accounting policies and the key sources of estimation uncertainty in these consolidated financial statements, which together are deemed critical to the results and financial position, are presented within the components of TSB Group's business model as shown in the table below. These areas are discussed in detail by the Audit Committee as set out in the corporate governance statement on pages 37 and 38.

Critical accounting estimates	reference
Effective interest rate methodology	Notes 1 and 7
Impairment provisioning	Note 9
Transitional impact of IFRS 9 *Financial Instruments* effective from 1 January 2018	Pages 79 to 81
Recoverability of deferred tax assets	Note 20
Customer remediation provision	Note 31

Key areas of significant judgement	reference
IT Migration Programme accounting	Notes 28 and 30

Index to the consolidated financial statements

TSB Group's primary consolidated financial statements are presented on pages 64 to 67. The notes to these consolidated financial statements are structured to follow TSB Group's business model as set out on page 7 and are listed below.

Consolidated balance sheet

as at 31 December 2017

	Note	2017 £ million	2016* £ million
Assets			
Cash, cash balances at central banks and other demand deposits		**7,563.8**	3,647.7
Financial assets held for trading:			
Derivative financial assets	26	**111.1**	143.2
Financial assets designated at fair value through profit or loss:			
Equity instruments	18	**17.2**	8.7
Available-for-sale financial assets	11	**2,123.3**	2,103.5
Loans and receivables:			
Loans to central banks		**56.0**	51.0
Loans to credit institutions	6	**329.2**	530.5
Loans and advances to customers	7	**30,854.2**	29,419.1
Other advances	10	**896.0**	799.0
Hedging derivative financial assets	26	**103.7**	104.3
Fair value adjustments for portfolio hedged risk		**(22.2)**	0.8
Property, plant and equipment	29	**172.7**	168.3
Intangible assets		**10.1**	2.6
Deferred tax assets	20	**68.6**	99.6
Other assets	30	**241.8**	117.4
Total assets		**42,525.5**	37,195.7
Liabilities			
Financial liabilities held for trading:			
Derivative financial liabilities	26	**37.5**	97.7
Financial liabilities at amortised cost:			
Borrowings from central banks		**5,625.7**	5.0
Deposits from credit institutions		**–**	2.3
Customer deposits	1	**30,520.6**	29,383.8
Repurchase agreements	4	**1,446.4**	1,409.6
Debt securities in issue	2	**1,318.7**	2,940.1
Subordinated liabilities	3	**405.3**	413.3
Other financial liabilities		**247.3**	228.6
Hedging derivative financial liabilities	26	**566.5**	529.1
Fair value adjustments for portfolio hedged risk		**42.2**	70.7
Provisions	31	**34.5**	10.8
Current tax liabilities		**6.8**	14.7
Other liabilities	31	**278.4**	225.0
Total liabilities		**40,529.9**	35,330.7
Equity			
Share capital	21	**5.0**	5.0
Share premium	21	**965.1**	965.1
Other reserves:			
Merger reserve	21	**616.5**	616.5
Capital reorganisation reserve	21	**(1,311.6)**	(1,311.6)
Capital reserve	21	**410.0**	410.0
Retained profits brought forward	21	**1,173.7**	1,045.9
Profit attributable to the shareholder for the current year	21	**118.7**	127.8
Valuation adjustments:			
Available-for-sale reserve	21	**18.7**	5.9
Cash flow hedging reserve	21	**(0.5)**	0.4
Shareholder's equity		**1,995.6**	1,865.0
Total equity and liabilities		**42,525.5**	37,195.7

* Certain balances have been re-presented to provide consistency with current year presentation which aligns to the presentation in the financial statements of the Company's ultimate parent undertaking, Banco de Sabadell SA (Sabadell).

The accompanying notes are an integral part of the consolidated financial statements. The consolidated financial statements on pages 61 to 106 were approved by the Board of Directors on 1 February 2018 and signed on its behalf by:

Paul Pester
Chief Executive Officer

Ralph Coates
Chief Financial Officer

Consolidated statement of comprehensive income

for the year ended 31 December 2017

	Note	2017 £ million	2016* £ million
Income statement:			
Interest and similar income	13	**1,080.6**	1,097.7
Interest and similar expense	13	**(175.3)**	(243.9)
Net interest income	13	**905.3**	853.8
Fee and commission income	14	**193.3**	197.5
Fee and commission expense	14	**(109.6)**	(97.3)
Net fee and commission income	14	**83.7**	100.2
Net gains/(losses) on financial assets and liabilities:			
Gains on derecognition of financial assets and liabilities not measured at fair value through profit or loss		**68.5**	32.5
Gains/(losses) on financial assets and liabilities held for trading		**6.6**	(5.5)
Gains on financial assets designated at fair value through profit or loss		**3.8**	–
Gains from hedge accounting	26	**24.5**	20.7
Gains/(losses) on derecognition of non-financial assets and liabilities		**5.8**	(2.6)
Other operating income	15	**1.6**	1.3
Other income		**194.5**	146.6
Total income		**1,099.8**	1,000.4
Total operating expenses	16	**(859.3)**	(731.1)
Operating profit before impairment losses and taxation		**240.5**	269.3
Impairment losses on loans and advances to customers	9	**(77.8)**	(87.3)
Profit before taxation		**162.7**	182.0
Taxation	19	**(44.0)**	(54.2)
Profit for the year	21	**118.7**	127.8
Other comprehensive income/(expense):			
Items that may be subsequently reclassified to profit or loss:			
Change in available-for-sale reserve:			
Change in fair value		**(4.5)**	114.0
Transfers to the income statement		**22.0**	(128.4)
Taxation thereon	20	**(4.7)**	4.0
	21	**12.8**	(10.4)
Change in cash flow hedging reserve:			
Change in the fair value of derivatives in cash flow hedges		**8.4**	48.6
Transfers to the income statement		**(9.3)**	(47.5)
Taxation thereon	20	**–**	0.2
	21	**(0.9)**	1.3
Other comprehensive income/(expense) for the year, net of taxation		**11.9**	(9.1)
Total comprehensive income for the year		**130.6**	118.7

* Certain amounts have been re-presented to provide consistency with current year presentation which aligns to the presentation in the financial statements of the Company's ultimate parent undertaking, Banco de Sabadell SA (Sabadell).

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated statement of changes in equity

for the year ended 31 December 2017

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2016	5.0	965.1	616.5	(1,311.6)	410.0	16.3	(0.9)	1,045.9	1,746.3
Comprehensive income:									
Profit for the year	–	–	–	–	–	–	–	127.8	127.8
Other comprehensive income/(expense)	–	–	–	–	–	(10.4)	1.3	–	(9.1)
Total comprehensive income	–	–	–	–	–	(10.4)	1.3	127.8	118.7
Balance at 31 December 2016	5.0	965.1	616.5	(1,311.6)	410.0	5.9	0.4	1,173.7	1,865.0
Balance at 1 January 2017	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**5.9**	**0.4**	**1,173.7**	**1,865.0**
Comprehensive income/(expense):									
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**118.7**	**118.7**
Other comprehensive (expense)/income	**–**	**–**	**–**	**–**	**–**	**12.8**	**(0.9)**	**–**	**11.9**
Total comprehensive income	**–**	**–**	**–**	**–**	**–**	**12.8**	**(0.9)**	**118.7**	**130.6**
Balance at 31 December 2017	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**18.7**	**(0.5)**	**1,292.4**	**1,995.6**

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated cash flow statement

for the year ended 31 December 2017

	Note	2017 £ million	2016 £ million
Cash flows from operating activities			
Profit before taxation		**162.7**	182.0
Adjustments for:			
Change in operating assets	32	**(1,477.8)**	(3,920.6)
Change in operating liabilities	32	**1,175.4**	3,990.2
Non-cash and other items	32	**114.0**	76.2
Taxation paid		**(25.5)**	(8.7)
Net cash provided by/(used in) operating activities		**(51.2)**	319.1
Cash flows from investing activities			
Purchase of property, plant and equipment		**(15.8)**	(35.9)
Purchase of financial assets		**(62.9)**	(779.2)
Interest received on financial assets		**83.3**	53.7
Proceeds on disposal of equity assets		**–**	25.3
Maturity/(Issue) of reverse repurchase agreements		**–**	20.3
Interest received on reverse repurchase agreements		**0.4**	2.2
Purchase of Sabadell shares		**(8.4)**	(5.2)
Net cash used in investing activities		**(3.4)**	(718.8)
Cash flows from financing activities			
Proceeds from borrowing from central banks		**5,615.0**	–
Interest paid on borrowings from central banks		**(6.4)**	–
Proceeds from debt securities issued		**497.5**	553.7
Repayment of debt securities in issue		**(2,128.4)**	(557.4)
Interest paid on debt securities		**(13.4)**	(40.6)
Interest paid on subordinated liabilities		**(22.1)**	(22.1)
Proceeds from /(Repayment of) repurchase agreements		**36.9**	1,408.6
Interest paid on repurchase agreements		**(8.4)**	(9.5)
Net cash provided by financing activities		**3,970.7**	1,332.7
Change in cash and cash equivalents		**3,916.1**	933.0
Cash and cash equivalents at 1 January	32	**3,647.7**	2,714.7
Cash and cash equivalents at 31 December		**7,563.8**	3,647.7

The accompanying notes are an integral part of the consolidated financial statements.

Notes to the consolidated financial statements

Sources of funding

Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets, that diversify our funding profile and our shareholder also provides some funding in the form of equity in the business.

Accounting policies relevant to sources of funding

(a) Financial liabilities
Financial liabilities is the term used to describe TSB Group's deposits and funding. It includes customer deposits, deposits from credit institutions, borrowings from central banks, debt securities in issue, subordinated liabilities, other financial liabilities and derivative financial liabilities (see accounting policy (j) under Managing financial risk).

Financial liabilities which are not derivatives are measured at amortised cost. Issues of financial liabilities measured at amortised cost are recognised on settlement date. A financial liability is derecognised from the balance sheet when TSB Group has discharged its obligations, the contract is cancelled or the contract expires.

Borrowings (which include deposits from credit institutions, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest rate method.

1. Customer deposits

	2017 £ million	2016 £ million
Bank accounts	**11,047.4**	9,938.8
Instant access saving deposits	**15,552.3**	15,221.4
Deposits with agreed maturity	**3,929.8**	4,209.6
Deposits redeemable at notice	**–**	26.0
Valuation adjustments	**(8.9)**	(12.0)
Total customer deposits	**30,520.6**	29,383.8

At 31 December 2017 £1,082.3 million (2016: £2,766.2 million) of customer deposits had a residual maturity of greater than one year. Valuation adjustments primarily reflect effective interest rate (EIR) asset balances, as explained below, and micro fair value hedge adjustments.

Significant estimate – effective interest rate methodology

TSB Group uses the effective interest rate method to determine the recognition of interest expense on customer deposits. At 31 December 2017, TSB Group had deferred, for accounting purposes, £11.7 million of interest expense in respect of bonus interest on certain savings products (2016: £15.0 million). This amount will be recognised as interest expense over management's estimate of the expected remaining life of the relevant savings balances. The assessment of this period requires management judgement including the extent to which recent historical repayment behaviour is indicative of future expected behaviour. Management considered credible alternative customer repayment profiles and concluded that no change to the repayment assumption was required and the impact of those alternative scenarios would not be material to the deferred interest expense asset.

Notes to the consolidated financial statements

Sources of funding (continued)

2. Debt securities in issue

	Balance at 1 Jan 2017 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2017 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Duncan Funding 2015-1 plc	**514.9**	**(57.1)**	**10.4**	**468.2**
Duncan Funding 2016-1 plc	**510.9**	**(158.4)**	**–**	**352.5**
Series 2017-1 Covered Bonds	**–**	**497.7**	**0.3**	**498.0**
Debt securities issued in an EU Member State not requiring filing of a prospectus	**1,914.3**	**(1,913.0)**	**(1.3)**	**–**
Total debt securities in issue	**2,940.1**	**(1,630.8)**	**9.4**	**1,318.7**

	Balance at 1 Jan 2016 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2016 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Duncan Funding 2015-1 plc	544.3	(65.0)	35.6	514.9
Duncan Funding 2016-1 plc	–	500.2	10.7	510.9
Debt securities issued in an EU Member State not requiring filing of a prospectus	2,355.3	(437.0)	(4.0)	1,914.3
Total debt securities in issue	2,899.6	(1.8)	42.3	2,940.1

	Date of issue	Amount 31 Dec 2017 £ million	Amount 31 Dec 2016 £ million	Interest rate at 31 Dec 2017	Maturity date	Issue currency	Target of offering
Issuing entity							
Cape Funding No. 1 plc	05/2014	–	1,914.3	–	–	–	–
Duncan Funding 2015-1 plc	11/2015	**202.3**	259.0	1.21281%	09/2020	GBR	Institutional
Duncan Funding 2015-1 plc	11/2015	**265.9**	255.9	0.14900%	09/2020	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**81.8**	115.2	0.07100%	04/2021	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**270.7**	395.7	1.15375%	04/2021	GBR	Institutional
Series 2017-1 Covered Bonds	12/2017	**498.0**	–	0.76219%	12/2022	GBR	Institutional
Total debt securities in issue		**1,318.7**	2,940.1				

3. Subordinated liabilities

	2017 £ million	2016 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.1**	383.8
Accrued interest	**3.4**	3.4
Fair value hedge accounting adjustments	**17.8**	26.1
Total subordinated liabilities	**405.3**	413.3

TSB Banking Group plc (the Company) issued, in 2014, £385.0 million of fixed/floating rate reset callable subordinated Tier 2 notes at an issue price of 99.493% of the principal amount. The notes pay interest at a rate of 5.75% per annum, payable semi-annually in arrears until 6 May 2021 at which time the interest rate becomes 3 month LIBOR plus 3.43% per annum payable quarterly in arrears. The Company has the option to redeem these notes on 6 May 2021 and quarterly thereafter, subject to approval of the PRA.

Notes to the consolidated financial statements

Sources of funding (continued)

4. Repurchase agreements

At 31 December 2017, TSB Group had entered into repurchase agreements that transferred legal title of certain UK gilts in return for cash, together with an agreement to repurchase the assets at a later date and at a predetermined price. The gilts were not derecognised from TSB Group's consolidated balance sheet as substantially all of the rewards, including interest income, and risks, including credit and interest rate risks, are retained by TSB Group. In all cases, the transferee has the right to sell or repledge the gilts concerned, subject to delivering the securities at the repurchase date.

The table below presents the carrying values, including accrued interest, of the transferred gilts and the associated repurchase agreement liabilities. The associated liabilities represent TSB Group's obligation to repurchase the transferred assets.

	Carrying amount of transferred assets 2017 £ million	Carrying amount of associated liabilities 2017 £ million	Carrying amount of transferred assets 2016 £ million	Carrying amount of associated liabilities 2016 £ million
Repurchase agreements with credit institutions	–	–	932.4	751.0
Repurchase agreements with non-credit institutions	**1,444.7**	**1,446.4**	663.8	658.6
Repurchase agreements	**1,444.7**	**1,446.4**	1,596.2	1,409.6

5. Fair value of financial liabilities

The following table summarises the carrying values and fair values of financial liabilities presented on TSB Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amount which will actually be paid on the maturity or settlement date.

		2017		2016	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial liabilities					
Customer deposits	1	**30,520.6**	**30,558.9**	29,383.8	29,451.5
Repurchase agreements	4	**1,446.4**	**1,446.4**	1,409.6	1,417.1
Debt securities in issue	2	**1,318.7**	**1,328.0**	2,940.1	2,950.2
Subordinated liabilities	3	**405.3**	**427.3**	413.3	403.4
Trading derivative liabilities	26	**37.5**	**37.5**	97.7	97.7
Hedging derivative liabilities	26	**566.5**	**566.5**	529.1	529.1

The carrying amount of borrowings from central banks, deposits from credit institutions and other financial liabilities is a reasonable approximation of fair value. Fair value is the price that would be paid to transfer a liability (or sell an asset) in an orderly transaction between market participants at the measurement date. The fair values of TSB Group's financial liabilities that are traded in active markets are based on current offer prices. For those instruments which do not have an active market, fair values have been determined using valuation techniques which include reference to recent arm's length transactions, or reference to other instruments with characteristics similar to those of the instruments held by TSB Group. Valuation techniques used include discounted cash flow analysis and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by TSB Group. Derivative financial instruments are the only financial liabilities of TSB Group that are carried at fair value.

Valuation hierarchy of financial instruments

Financial instruments carried at fair value, or for which fair values are disclosed, have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 - Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities.
Level 2 - Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data.
Level 3 - Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data.

Notes to the consolidated financial statements

Sources of funding (continued)

5. Fair value of financial liabilities (continued)

The table below analyses the fair values of TSB Group's financial liabilities.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2017					
Customer deposits	**–**	**30,558.9**	**–**	**30,558.9**	**30,520.6**
Repurchase agreements	**–**	**1,446.4**	**–**	**1,446.4**	**1,446.4**
Debt securities in issue	**1,328.0**	**–**	**–**	**1,328.0**	**1,318.7**
Subordinated liabilities	**–**	**427.3**	**–**	**427.3**	**405.3**
Trading derivative liabilities	**–**	**37.5**	**–**	**37.5**	**37.5**
Hedging derivative liabilities	**–**	**566.5**	**–**	**566.5**	**566.5**
At 31 December 2016					
Customer deposits	–	29,451.5	–	29,451.5	29,383.8
Repurchase agreements	–	1,417.1	–	1,417.1	1,409.6
Debt securities in issue	1,035.8	1,914.4	–	2,950.2	2,940.1
Subordinated liabilities	–	403.4	–	403.4	413.3
Trading derivative liabilities	–	97.7	–	97.7	97.7
Hedging derivative liabilities	–	529.1	–	529.1	529.1

The fair value of customer deposits repayable on demand and repurchase agreements is considered to be equal to their carrying value. The fair value for all other customer deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities. TSB Group's subordinated liabilities and derivative financial liabilities, which comprise interest rate swaps, are primarily valued using discounted cash flows where the most significant input is interest yield curves developed from publicly quoted rates and by reference to instruments with similar risk characteristics as the instruments held by TSB Group.

Loans

Funds deposited with TSB Group are primarily used to support lending to customers. TSB Group lends money to customers using different products, including mortgages, credit cards, unsecured personal loans and overdrafts. A portion of the funds are held in reserve – we call that our liquidity portfolio, which enables TSB Group to meet unexpected future funding requirements.

Accounting policies relevant to loans

(b) Financial assets

'Financial assets' is the term used to describe TSB Group's loans to customers and other institutions. It includes loans and advances to customers, loans to credit institutions, loans to central banks, available-for-sale financial assets, cash and cash and balances with central banks and other demand deposits, derivative financial assets (see accounting policy (j) under Managing financial risk), and other advances.

On initial recognition, financial assets which are not derivatives are classified as loans and receivables or available-for-sale financial assets. Purchases and sales of financial assets and liabilities are recognised on trade date, being the date that TSB Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when TSB Group has transferred its contractual right to receive the cash flows from the assets and either:

- Substantially all of the risks and rewards of ownership have been transferred; or
- TSB Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

(i) Loans and receivables

Loans and receivables include loans and advances to customers, loans and advances to credit institutions and other eligible assets. Loans and advances are initially recognised when cash is advanced to the borrower at fair value inclusive of transaction costs or, for other eligible assets, their fair value at the date of acquisition. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method less provision for impairment.

Where TSB Group enters into securitisation transactions to finance certain loans and advances to customers using a structured entity funded by the issue of debt, these loans and advances continue to be recognised by TSB Group together with a corresponding liability for the funding where TSB Group retains control of the structured entity.

(ii) Available-for-sale financial assets

TSB Group classifies financial assets as available-for-sale when the instruments are not derivatives and are not held for trading purposes or otherwise designated at fair value through profit or loss, or at amortised cost. Available-for-sale investments are held at fair value with gains and losses arising from changes in fair value recognised in other comprehensive income. Interest is calculated using the effective interest method and is recognised in the income statement in net interest income. On disposal, the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement.

(iii) Repurchase agreements

Financial instruments sold under a repurchase agreement, under which substantially all the risks and rewards of ownership are retained by TSB Group, continue to be recognised on the balance sheet and the sale proceeds are recognised as a financial liability. The difference between the sale and repurchase price is recognised over the life of the agreement as interest expense using the effective interest method.

Notes to the consolidated financial statements

Loans (continued)

(c) Impairment of financial assets

(i) Accounted for at amortised cost

At each balance sheet date TSB Group assesses whether, as a result of one or more events occurring after initial recognition, there is objective evidence that a financial asset or group of financial assets has become impaired.

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original EIR. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current EIR.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an EIR basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

(ii) Collective basis

Impairment allowances for portfolios of homogenous loans such as residential mortgages, personal loans and credit card balances, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

(iii) Homogenous groups of loans

Impairment is assessed on a collective basis for homogenous groups of loans that are not considered individually impaired. The asset is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment.

The criteria that TSB Group uses to determine that there is objective evidence of an impairment loss may include:

- Delinquency in contractual payments of principal and/or interest;
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty;
- Restructuring of debt to reduce the burden on the borrower;
- Breach of loan covenants or conditions; and
- Initiation of bankruptcy or individual voluntary arrangement proceedings.

In respect of TSB Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or in certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by TSB Group to reduce any differences between loss estimates and actual loss experience.

(iv) Write-offs

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the statement of comprehensive income.

Notes to the consolidated financial statements

Loans (continued)

6. Loans to credit institutions

	2017 £ million	2016 £ million
Cash deposits held	**329.2**	530.5
Total loans to credit institutions	**329.2**	530.5

At 31 December 2017 £124.1 million of loans to credit institutions (2016: £196.3 million) had a contractual residual maturity of greater than one year. Loans to credit institutions comprise cash deposits held by TSB Group's securitisation and covered bond entities.

7. Loans and advances to customers

	2017 £ million	2016 £ million
Secured loans	**28,285.0**	27,039.0
Other term loans	**1,491.8**	1,299.4
Receivable on demand	**856.8**	829.3
Commercial credit	**133.9**	158.8
Impaired assets	**128.0**	140.0
Other valuation adjustments	**30.3**	26.3
Gross loans and advances to customers	**30,925.8**	29,492.8
Allowance for impairment losses (note 9)	**(71.6)**	(73.7)
Loans and advances to customers	**30,854.2**	29,419.1

At 31 December 2017 £28,178.2 million of loans and advances to customers (2016: £26,851.8 million) had a contractual residual maturity of greater than one year. Other valuation adjustments reflect effective interest rate asset balances and micro fair value hedge adjustments.

Significant estimate – effective interest rate methodology

TSB Group uses the effective interest rate method to determine the recognition of interest income on loans and advances to customers. At 31 December 2017, TSB Group had recognised, for accounting purposes, £21.1 million in respect of net fees paid in respect of mortgage originations and early redemption fee income. This amount will be reflected as a reduction in interest income over the expected remaining life of the mortgage balances. The assessment of this period requires management judgement. Management considered credible alternative mortgage repayment profiles and concluded that no change to the repayment assumption was required and that the impact of those scenarios would not be material to the carrying amount of the net asset.

Securitisation and covered bond programmes

Loans and advances to customers include loans securitised under TSB Group's securitisation programmes, the majority of which have been sold to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by TSB Group, the structured entities are consolidated fully and all of these loans are retained on TSB Group's balance sheet, with the related notes in issue included within debt securities in issue.

Covered bond programmes

Certain loans and advances to customers have been assigned to a limited liability partnership to provide security for issues of covered bonds by the TSB Group. TSB Group retains all of the risks and rewards associated with these loans and the partnership is consolidated fully with the loans on TSB Group's balance sheet, and the related covered bonds in issue included within debt securities in issue.

Notes to the consolidated financial statements

Loans (continued)

7. Loans and advances to customers (continued)

TSB Group's securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below.

	31 December 2017		31 December 2016	
	Loans and advances securitised(1) £ million	Liability £ million	Loans and advances securitised(1) £ million	Liability £ million
Securitisation programmes:				
Cape Funding No. 1 plc	**–**	**–**	2,243.8	2,341.1
Duncan Funding 2015-1 plc	**1,598.9**	**1,679.0**	1,773.3	1,879.1
Duncan Funding 2016-1 plc	**2,717.4**	**2,878.7**	3,079.7	3,244.8
	4,316.3	**4,557.7**	7,096.8	7,465.0
Less held by TSB Group		**(3,737.0)**		(4,524.9)
Total securitisation notes		**820.7**		2,940.1
Covered Bonds:				
Series 2017-1 Covered Bonds	**699.3**	**498.0**	–	–
Total (note 2)		**1,318.7**	–	2,940.1

(1) Due to the nature of the securitisation programmes, cash arising from mortgage repayments will be retained for periods of time before being invested in replacement mortgage assets or being distributed to note holders.

Securitisation programmes

Cash deposits of £313.0 million (2016: £530.5 million) held by TSB Group are restricted in use to repayment of the debt securities issued by the structured entities and other legal obligations. TSB Group recognises the full liabilities associated with its securitisation programmes within debt securities in issue, although the obligations of TSB Group are limited to the cash flows generated from the underlying assets.

Covered bond programmes

Cash deposits of £16.2 million (2016: £nil) held by TSB Group are restricted in use to repayment of the term advances related to covered bonds and other legal obligations. At 31 December 2017 TSB Group had over-collateralised the covered bond programmes in order to: meet the programme terms; secure the rating of the covered bonds; and to provide operational flexibility. The obligations of TSB Group to provide collateral may increase due to the formal requirements of the programmes. TSB Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

8. Commitments arising from the banking business

In the normal course of business, TSB Group provides commitments to lend to its customers as presented below.

	2017 £ million	2016 £ million
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Mortgage offers made	**1,004.3**	1,489.8
Credit cards	**2,571.3**	2,695.4
Other	**1,107.0**	1,091.8
Total commitments	**4,682.6**	5,277.0

Of the amounts shown above, £1,282.9 million (2016: £1,778.3 million) was irrevocable. All commitments to lend to customers shown in the table above have a contractual maturity of less than one year.

Notes to the consolidated financial statements

Loans (continued)

9. Allowance for impairment losses on loans and receivables

	Specific coverage determined individually £ million	Specific coverage determined collectively £ million	Incurred but not reported coverage £ million	Total £ million
At 1 January 2016	1.1	52.6	17.5	71.2
Movements reflected in the income statement	0.5	84.3	2.5	87.3
Movements not reflected in the income statement:				
Utilisations	(1.0)	(100.9)	–	(101.9)
Recoveries	–	17.1	–	17.1
At 31 December 2016	**0.6**	**53.1**	**20.0**	**73.7**
Movements reflected in the income statement	**0.5**	**76.4**	**0.9**	**77.8**
Movements not reflected in the income statement:				
Utilisations	**(0.7)**	**(89.8)**	**–**	**(90.5)**
Recoveries	**–**	**10.9**	**–**	**10.9**
Other movements	**–**	**(13.6)**	**13.3**	**(0.3)**
At 31 December 2017	**0.4**	**37.0**	**34.2**	**71.6**

Included in total allowance for impairment losses on loans and advances to customers is £37.4 million (2016: £53.7 million) relating to lending that was determined to be impaired.

10. Other advances

	2017 £ million	2016 £ million
Items in the course of collection from credit institutions	**252.6**	213.8
Items in the course of collection from non-credit institutions	**7.8**	6.6
Collateral placed at central clearing houses	**635.3**	559.1
Other collateral placed with credit institutions	**0.3**	19.5
Total other advances	**896.0**	**799.0**

Significant estimates – impairment provisioning

The allowance for impairment losses is management's best estimate of losses incurred in the portfolio at the balance sheet date. At 31 December 2017 TSB Group recognised an impairment allowance against loans and advances to customers of £71.6 million (2016: £73.7 million).

The impairment allowance is subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is inherently difficult to estimate how changes in one or more of these factors might impact the impairment allowance. However, given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices had been 10% lower than those estimated at 31 December 2017, the allowance for impairment losses would have been approximately £4.8 million higher (2016: £8.0 million higher).

The adequacy of the provision is estimated using models which use a variety of inputs, including recent historical experience to estimate the level of incurred losses in the portfolio. In certain circumstances adjustments are made to the modelled outcomes to reflect where, in management's judgement, the modelled outcomes are not sufficiently sensitive to current economic conditions. At 31 December 2017, the impairment allowance included £22.8 million of post model adjustments (2016: £25.4 million).

Notes to the consolidated financial statements

Loans (continued)

11. Available-for-sale financial assets

	2017 £ million	2016 £ million
Visa Inc. convertible preferred stock	**7.0**	5.2
UK Gilts	**1,721.5**	1,872.8
Supranational and development bank bonds	**394.8**	225.5
Total available-for-sale financial assets	**2,123.3**	2,103.5

At 31 December 2017 UK gilts with a carrying value, including accrued interest, of £1,444.7 million (2016: £663.8 million) were subject to repurchase agreements (note 4). No other available-for-sale financial assets had been pledged as collateral (2016: £nil). At 31 December 2017 and 2016 all of the available-for-sale financial assets had a contractual maturity of greater than one year.

In June 2016, TSB Group received Visa Inc. convertible preferred stock as partial consideration for the sale of its share in Visa Europe to Visa Inc. At 31 December 2017, TSB Group's investment was recognised as an available-for-sale asset at its fair value of £7.0 million (2016: £5.2 million). The key inputs to the valuation are the conversion rate of the preferred stock to Visa Inc. common stock, the fair value of Visa Inc. common stock and the US Dollar to Sterling exchange rate. Determining the fair value of this investment requires management judgement as the preferred stock is not transferrable and conversion to Visa Inc. common stock is subject to reduction to reflect potential litigation losses incurred by Visa.

The most significant unobservable input to the valuation is an estimate of potential litigation losses which could reduce the conversion rate of the preferred stock. The potential fair value of TSB Group's investment in Visa Inc. convertible preferred stock could be up to £21.0 million greater (2016: £15.6 million greater) if no reductions were assumed in the conversion of the preferred stock and there were no restrictions on transferability.

12. Fair value of financial assets

The following table summarises the carrying values of financial assets presented on TSB Group's consolidated balance sheet and the fair value of these financial instruments. The fair values presented are at a specific date and may be significantly different from the amount which will actually be received on the maturity or settlement date.

		2017		2016	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial assets					
Loans and advances to customers	7	**30,854.2**	**30,854.0**	29,419.1	29,464.7
Available-for-sale financial assets	11	**2,123.3**	**2,123.3**	2,103.5	2,103.5
Trading derivative financial assets	26	**111.1**	**111.1**	143.2	143.2
Hedging derivative financial assets	26	**103.7**	**103.7**	104.3	104.3
Equity instruments	18	**17.2**	**17.2**	8.7	8.7

The carrying amount of cash, cash balances at central banks and other demand deposits; loans and advances to central banks; loans and advances to credit institutions and other advances is a reasonable approximation of fair value.

Valuation hierarchy of financial assets carried at amortised cost

The table below analyses the fair values of financial assets carried at amortised cost and for which fair value is disclosed.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Loans and advances to customers	**–**	**–**	**30,854.0**	**30,854.0**	**30,854.2**
At 31 December 2017	**–**	**–**	**30,854.0**	**30,854.0**	**30,854.2**
At 31 December 2016	–	–	29,464.7	29,464.7	29,419.1

Notes to the consolidated financial statements

Loans (continued)

12. Fair value of financial assets (continued)

TSB Group provides loans at both fixed and variable rates. Fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by TSB Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period.

Valuation hierarchy of financial assets carried at fair value

The table below analyses the fair values of the financial assets of TSB Group which are carried at fair value.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2017					
Available-for-sale financial assets	**2,116.3**	**–**	**7.0**	**2,123.3**	**2,123.3**
Trading derivative assets	**–**	**111.1**	**–**	**111.1**	**111.1**
Hedging derivative assets	**–**	**103.7**	**–**	**103.7**	**103.7**
Equity instruments	**17.2**	**–**	**–**	**17.2**	**17.2**
Total	**2,133.5**	**214.8**	**7.0**	**2,355.3**	**2,355.3**
At 31 December 2016					
Available-for-sale financial assets	2,098.3	–	5.2	2,103.5	2,103.5
Trading derivative assets	–	143.2	–	143.2	143.2
Hedging derivative assets	–	104.3	–	104.3	104.3
Equity instruments	8.7	–	–	8.7	8.7
Total	2,107.0	247.5	5.2	2,359.7	2,359.7

A description of the fair value levels is included in Note 5 on page 70.

Level 3 financial assets	2017 £ million	2016 £ million
Balance at 1 January	**5.2**	22.4
Disposal of share in Visa Europe	**–**	(22.4)
Acquisition of Visa Inc. convertible preferred stock	**–**	4.5
Gains recognised in ‘changes in fair value’ in other comprehensive income	**1.8**	0.7
Balance at 31 December	**7.0**	5.2

Available-for-sale gilts and supranational and development bank bonds are valued using quoted market prices and are therefore classified as Level 1 assets. The only Level 3 financial asset carried at fair value at 31 December 2017 is the available-for-sale investment in Visa Inc. convertible preferred stock. A description of the valuation approach and the key unobservable inputs to the valuation are explained on page 77. Derivative financial assets are primarily interest rate swaps and are valued using a discounted cash flow model where the most significant input is interest yield curves which are developed from publicly quoted rates.

Notes to the consolidated financial statements

Loans (continued)

IFRS 9 *Financial Instruments – effective from 1 January 2018*

In July 2014, the IASB issued IFRS 9 *Financial Instruments*, which replaces IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 fundamentally changes the way financial instruments are accounted for and includes requirements in three areas; classification and measurement of financial assets and liabilities, impairment of financial assets, and hedge accounting. IFRS 9 was endorsed by the EU in November 2016 and will be applied by TSB Group from its mandatory application date of 1 January 2018. The classification and measurement and impairment requirements will be applied retrospectively by adjusting the opening balance sheet at 1 January 2018. Comparative period amounts will not be restated as there is no requirement to do so.

1. Overview of the requirements of IFRS 9

- *Classification and measurement* **-** The classification and measurement of financial assets will depend on how these are managed (the business model) and their contractual cash flow characteristics. The classification of the financial asset determines whether it is measured at amortised cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVPL). The requirements for the classification of financial liabilities, as they currently apply to TSB Group, remain unchanged.

  The majority of TSB Group's financial assets are loans and advances to customers currently classified, under IAS 39 as loans and receivables and held at amortised cost. As outlined on page 37, the adoption of IFRS 9 from 1 January 2018 has not resulted in any material changes to the measurement basis of TSB Group's financial assets.

- *Impairment* **-** The impairment requirements of IFRS 9 apply to financial assets measured at amortised cost and debt instruments measured at FVOCI. At initial recognition, an impairment allowance is required for expected credit losses (ECL) resulting from default events expected within the next 12 months (12 month ECL). In the event of a significant increase in credit risk, allowance is required for ECL resulting from default events expected over the estimated life of the financial instrument (lifetime ECL). IFRS 9 requires the financial asset to be allocated to one of three 'stages' as follows:

  - Stage 1 - Financial assets which have not experienced a significant increase in credit risk since they were originated. Recognition of a 12 month ECL is required. Interest income on stage 1 financial assets is calculated on the gross carrying amount of the financial asset;
  - Stage 2 – Financial assets which have experienced a significant increase in credit risk. For financial assets in stage 2, recognition of a lifetime ECL impairment allowance is required. Interest income on stage 2 financial assets is calculated on the gross carrying amount of the financial asset; and
  - Stage 3 - Financial assets which have experienced one of more events that have had a detrimental impact on the estimated future cash flows and are considered to be credit impaired. Like stage 2, recognition of a lifetime expected ECL impairment allowance is required. However, interest income on stage 3 loans is calculated on the financial asset balance net of the impairment allowance.

  In respect of financial assets which were considered to be credit impaired at the date they were purchased or originated, the cumulative change in lifetime expected credit losses since initial recognition is required to be recognised as an impairment provision.

  The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period. This is primarily achieved by considering the change in the probability of default occurring over the remaining life of the financial instrument as described in section 3 on the following page.

  The assessment of credit risk and the estimation of ECL should be unbiased and probability-weighted, and should incorporate all available information which is relevant to the assessment and which is available without undue cost or effort. This should include reasonable and supportable forecasts of economic conditions at the reporting date.

  As a result, the recognition and measurement of impairment is intended to be more forward looking than under the IAS 39 incurred loss model and the resulting impairment charge is expected to be more volatile. The application of IFRS 9 is expected to result in an increase in the total level of impairment allowances as outlined on page 37. This increase primarily arises in TSB's unsecured portfolios and reflects the effect on unimpaired exposures of the replacement of a 3 month loss emergence period under IAS 39 with a 12 month expected loss provision (or shorter in the case of unsecured loans with residual maturity less than 12 months)

- *Hedge accounting* - IFRS 9 does not explicitly address the macro hedge accounting that is undertaken by TSB Group and includes an accounting policy choice to continue applying the hedge accounting requirements of IAS 39, which TSB Group expects to exercise. The revised hedge accounting disclosures required by the related amendments to IFRS 7 *Financial Instruments: Disclosures* will be implemented on transition to IFRS 9 in 2018.

Loans (continued)

IFRS 9 *Financial Instruments* (continued)

2. Overview of TSB Group's implementation of IFRS 9

Within TSB Group, a joint Finance and Risk IFRS 9 Implementation Programme (the Programme) has been preparing for the implementation of IFRS 9 since 2014. The Programme is co-sponsored by the TSB Group Chief Financial Officer and Chief Risk Officer and a Steering Committee has been established comprising senior management from Finance, Risk and other functional experts when required. The Programme has developed risk modelling methodologies for the calculation of impairment, defined TSB Group accounting policies and is designing data systems and process requirements. The Programme's focus in 2017 has been to complete the build of the models and IT infrastructure and testing operational readiness which has included a period of parallel run to support the refinement of key model parameters and policy decisions.

The adoption of IFRS 9 at 1 January 2018, by applying the accounting policies and ECL measurement methodologies outlined below, is expected to result in an increase in the allowance for loans losses of £96 million with a corresponding increase in deferred tax assets of £24 million leading to a decrease in shareholder's equity of £72 million. The application of the classification and measurement requirements is not expected to result in any material changes to the measurement of TSB Group's financial assets.

3. Comparison of TSB Group's existing IAS 39 accounting policies with IFRS 9

The accounting policies and critical accounting estimates and judgements for the impairment of loans and advances (in accordance with IAS 39) are set out on pages 73 and 76. The equivalent policies for financial assets at amortised cost and at FVOCI (in accordance with IFRS 9) are being developed as described below.

- *Definition of default*

  TSB Group has substantially aligned the IFRS 9 and regulatory definitions of default, the definition of credit impaired and the definition of non-performing exposure. This has resulted in loans that are more than 90 days past due, or considered by management as unlikely to pay their obligations in full without realisation of collateral, being considered as in default for IFRS 9. TSB Group policy is not to rebut the presumption in IFRS 9 that loans which are more than 90 days past due are in default.

- *Stage 1*

  Under IFRS 9, financial assets which are not considered to have significantly increased in credit risk have loss allowances measured at an amount equal to 12 months ECL. This 12 month time horizon will be equal to (in respect of TSB Group's mortgage loan portfolios) or longer than (in respect of TSB Group's unsecured and business banking portfolios) the period estimated under IAS 39. This will result in IFRS 9 allowances being larger than those calculated in accordance with IAS 39.

- *Stage 2*

  Financial assets are considered to be in stage 2 when their credit risk has increased significantly since initial recognition. This has resulted in an increased allowance relative to IAS 39 as the result of the recognition of lifetime ECL for populations that are not currently considered to be credit impaired under IAS 39.

  The main factor that is considered by TSB Group is an increase in the residual lifetime Probability of Default (PD) since initial recognition. A loan will be considered to have experienced a significant increase in credit risk, and be transferred from stage 1 to stage 2 if the residual lifetime PD has increased by a factor of 2 times the origination PD and the increase is at least 10 bps (for mortgages) and between 30 and 100 bps for unsecured products. As a secondary assessment criterion, financial assets that are in forbearance but not in default are considered to have experienced significant increase in credit risk and will be in stage 2. As a backstop, TSB Group does not rebut the presumption in IFRS 9 that all financial assets that are more than 30 days past due have experienced a significant increase in credit risk.

  In respect of loans, TSB Group does not use the practical expedient available in IFRS 9 which permits low credit risk loans (i.e. those considered investment grade) to remain in Stage 1 without an assessment of significant increase ('low credit risk exemption'). In respect of TSB Group's investment grade debt securities, TSB Group does take advantage of the low credit risk exemption and categorises these financial assets as stage 1.

Notes to the consolidated financial statements

Loans (continued)

IFRS 9 *Financial Instruments* (continued)

- *Stage 3*
  Financial assets will be included in stage 3 when there is objective evidence of credit impairment. Under IFRS 9, TSB Group assesses a loan as stage 3 when contractual payments of either principal or interest are past due for more than 90 days, the debtor is assessed as unlikely to pay, or the loan is otherwise considered to be in default. This 90 days past due time horizon will be shorter than the 180 day period applied under IAS 39 in respect of TSB Group's mortgage loan portfolios and will be longer than the 60 days period applied under IAS 39 in respect of TSB Group's unsecured and business banking portfolios).

- *Purchased or originated credit impaired (POCI)*
  Financial assets that are credit impaired at the date of their purchase or origination will be reported in a separate POCI category and will recognise the cumulative change in lifetime expected credit loss since origination as a loss allowance. Subsequent to origination, POCI financial assets that no longer meet the stage 3 criteria will no longer be considered to be credit impaired but will continue to be reported as POCI.

- *Write-off of financial assets*
  TSB Group's policy on the write-off of loans and advances, included on page 73, is expected to remain unchanged.

4. Methodologies applied to measure 12-month and lifetime expected credit losses

ECLs are calculated using three main components:

- a probability of default (PD);
- a loss given default (LGD); and
- the exposure at default (EAD).

For accounting purposes, the 12 month and lifetime PDs represent the probability of a default occurring over the next 12 months or the lifetime of the financial instruments, respectively, based on conditions existing at the balance sheet date and future economic conditions that affect credit risk. The LGD represents losses expected on default, taking into account the mitigating effect of collateral, its expected value when realised and the time value of money. The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default event together with any expected drawdown of a committed facility.

The 12 month ECL is calculated by multiplying the 12 month PD, LGD and EAD. Lifetime ECL is calculated using the lifetime PD, and the appropriate LGD and EAD based on the modelled remaining behavioural life of the financial asset. TSB Group bases the ECL calculations on the systems used to calculate regulatory expected losses. This is considered to be most efficient given similarities in the calculations. However, certain adjustments are required to the Basel risk components (PD, LGD, and EAD) to meet the IFRS 9 requirements. The main adjustments necessary to Basel risk components are explained in the table below:

Model	Regulatory capital models	IFRS 9 models
Probability of Default	• Through the cycle (represents long-run averaged throughout a full economic cycle). • The definition of default includes a backstop of more than 90 days past due, although this has been modified to more than 180 days past due for mortgages.	• Forward in time (based on current conditions, adjusted to take into account estimates of future economic conditions). • Definition of default for IFRS 9 will use a quantitative threshold of more than 90 days past due for all portfolios.
Exposure at default	• Cannot be lower than current balance.	• Amortisation and expected prepayments captured for term products.
Loss given default	• Downturn LGD (consistent losses expected to be suffered during a severe but plausible economic downturn). • Regulatory floors may apply to mitigate risk of underestimating downturn LGD due to lack of historical data. • Discounted using the cost of capital. • All collection costs included.	• Expected LGD (based on estimate of LGD including the expected impact of future economic conditions such as changes in value of collateral). • No floors. • Discounted using the original effective interest rate of the loan. • Only costs associated with obtaining/selling collateral included.
Other		• Discounted back from point of default to balance sheet date.

The measurement of ECL also requires the use of multiple economic scenarios to calculate a probability weighted forward looking estimate. TSB Group has considered five scenarios as part of an overarching governance framework for the use of forecast economic scenarios for planning, stress testing and IFRS 9 and has selected three of these for use in measuring ECL for IFRS 9. The base scenario reflects a supportive global economic environment and gradual normalisation of monetary policy. An upside scenario, reflecting improving productivity, and a down side scenario, reflecting increasing inflation and more hawkish central bank policy, are also used for IFRS 9. The weighting of these scenarios reflects a mild skew to the downside. Transfers between stages capture the effects of the application of these probability weighted forward-looking macroeconomic variables.

Notes to the consolidated financial statements

Income

We earn income in the form of interest that we receive on the loans we make to customers and we pay interest to savings and bank account customers on the money they deposit with us and to providers of other forms of funding. We also earn other income in the form of fees and charges from the provision of banking services and commissions from the sale of certain third party products such as general insurance.

Accounting policies relevant to income

(d) Interest income and expense

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the EIR method. The EIR method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense. The EIR is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by TSB Group that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument and all other premiums or discounts. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see accounting policy (c) on impairment of financial assets).

(e) Fees and commission income and expense

Fees and commissions which are not an integral part of the EIR are generally recognised when the service has been provided.

13. Net interest income

	2017 £ million	2016 £ million
Interest and similar income		
Cash, cash balances at central banks and other demand deposits	**13.5**	11.0
Available-for-sale financial assets	**44.7**	28.9
Loans to credit institutions	**0.9**	3.4
Derivative financial instruments	**(33.3)**	(8.9)
Loans and advances to customers	**1,054.8**	1,063.3
Total interest and similar income	**1,080.6**	1,097.7
Interest and similar expense		
Deposits from credit institutions	**(12.5)**	(0.2)
Repurchase agreements	**(8.0)**	(10.3)
Customer deposits	**(120.5)**	(174.0)
Debt securities in issue	**(11.9)**	(37.0)
Subordinated liabilities	**(22.4)**	(22.4)
Total interest and similar expense	**(175.3)**	(243.9)
Net interest income	**905.3**	853.8

Included within interest and similar income is £9.1 million (2016: £9.5 million) in respect of impaired financial assets.

Notes to the consolidated financial statements

Income (continued)

14. Net fee and commission income

	2017 £ million	2016 £ million
Fee and commission income		
Bank accounts	**84.5**	89.6
Credit and debit card fee income	**66.5**	62.5
Insurance commission income	**19.1**	21.0
Other	**23.2**	24.4
Total fee and commission income	**193.3**	197.5
Fee and commission expense		
Bank accounts	**(84.7)**	(74.4)
Credit and debit card fee expense	**(13.3)**	(8.8)
Other	**(11.6)**	(14.1)
Total fee and commission expense	**(109.6)**	(97.3)
Net fee and commission income	**83.7**	100.2

Fees and commissions which are an integral part of the EIR are recognised in net interest income.

15. Other operating income

	2017 £ million	2016 £ million
Rent receivable	**1.2**	1.3
Dividend income	**0.2**	–
Other income	**0.2**	–
Total other operating income	**1.6**	1.3

IFRS 15 *Revenue from Contracts with Customers – effective from 1 January 2018*

IFRS 15 '*Revenue from Contracts with Customers'* replaces IAS 18 '*Revenue'* and other existing revenue recognition interpretations. It describes the principles an entity must follow to measure and recognise revenue using a five step approach. The standard requires revenue to be recognised when goods or services are transferred to customers and the entity has satisfied its performance obligations under the contract, and at an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The standard does not apply to financial instruments or lease contracts.

IFRS 15 will be applied by TSB Group from 1 January 2018 and will require a change to TSB Group's accounting policy with respect to the recognition of commission income from the sale of insurance contracts. Specifically, under IAS 18, TSB Group recognised commission income from the renewal by customers of insurance contracts when the commission income was earned and received from the underwriter. Under IFRS 15, such renewal commission income is recognised when TSB Group satisfies its performance obligations under the relevant contract and management concludes that there is a high probability that there will be no significant reversal of the estimated income. There are no other changes to TSB Group's accounting policies as a result of adopting IFRS 15.

As a consequence, the adoption of IFRS 15 will result in the accelerated recognition of insurance commission income that was previously expected to be recognised during 2018 and 2019. At 1 January 2018, TSB Group will recognise an expected contract receivable of £5.9 million and an associated deferred tax liability of £1.6 million, leading to an expected £4.3 million increase in shareholder's reserves. In estimating the contract receivable, judgement has been applied in assessing the level of future policy renewals and policy early terminations.

Notes to the consolidated financial statements

Charges

Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our TSB Partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers' circumstances change and they are unable to repay the money they borrow from us causing us to incur impairment losses. Finally, TSB Group pays tax to HMRC on the profits we earn.

Accounting policies relevant to recognising charges

(f) Pensions and other post-retirement benefits

TSB Group operates defined contribution pension plans under which fixed contributions are paid. The costs of TSB Group's defined contribution plans are charged to the income statement, as an operating expense, in the period in which they fall due.

(g) Share-based compensation

TSB Group operates a number of cash settled share-based compensation plans, in respect of services received from certain of its Partners. The total expense is recognised over the vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. A corresponding credit is recognised as a liability. In addition, in some circumstances employees may provide services in advance of the grant date and therefore the liability is estimated for the purposes of recognising the expense during the period between service commencement period and grant date.

At the end of each reporting period, the fair value of the liability is measured with any changes in fair value recognised in operating expenses.

(h) Taxation

Current corporation tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

Deferred tax is determined using tax rates that have been enacted or substantively enacted by the balance sheet date that are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Notes to the consolidated financial statements

Charges (continued)

16. Operating expenses

	2017 £ million	2016 £ million
Partner (staff) costs		
Wages and salaries	**262.7**	254.0
Social security costs	**29.7**	28.0
Other pension costs	**32.7**	31.9
Share-based payments	**6.4**	3.4
Other staff costs	**38.9**	62.0
Total staff costs	**370.4**	379.3
Premises and equipment expenses		
Rent	**30.8**	33.6
Rates	**14.7**	16.0
Other	**31.3**	33.1
Total premises and equipment expenses	**76.8**	82.7
Other expenses		
Transitional Services Agreement (TSA) costs	**213.8**	91.8
Professional fees	**27.2**	21.3
Advertising and promotion	**59.0**	59.1
Financial Services Compensation Scheme (FSCS) levy	**0.3**	6.2
Other	**84.0**	67.1
Total other expenses	**384.3**	245.5
Depreciation of property plant and equipment	**27.5**	23.1
Depreciation of intangible assets	**0.3**	0.5
Total operating expenses	**859.3**	731.1

The monthly average number of Partners on a headcount basis during the year was 8,583 (2016: 8,296), all of whom were employed in the UK. Included in Partner costs is remuneration paid to key management personnel as set out in note 28(i) on page 102. Included in other expenses are fees paid to TSB Group's auditors as set out in the table below:

Auditors' remuneration	2017 £ million	2016 £ million
Fee for the audit of the financial statements of TSB Banking Group plc	**0.1**	0.1
Fee for the audit of TSB Group's subsidiaries	**2.2**	1.7
Non audit fees	**0.3**	0.4
Total fees payable to TSB Group's auditors	**2.6**	2.2

The 2017 fee for the audit of TSB Group's subsidiaries includes audit related services performed during the year to support the Sabadell interim audit and audit procedures relating to TSB Group's IFRS 9 programme.

17. Directors' emoluments

The remuneration of the Directors during the year was as follows:

	2017 £ 000	2016 £ 000
Aggregate remuneration paid to Directors in respect of qualifying services	**3,008**	2,884
Aggregate cash received under long-term incentive arrangements	**83**	1,803
Total	**3,091**	4,687

Details of the highest paid Director are set out on page 51 in the Remuneration review. The table below presents the number of Directors who:

	2017 Number	2016 Number
Exercised share options	**1**	2
Received shares under long term incentive schemes	**1**	1
Accrued pension benefits under defined contribution pension schemes	**1**	–

Notes to the consolidated financial statements

Charges (continued)

18. Share-based payments

Operating expenses include the following in respect of TSB Group's share-based compensation schemes, all of which are accounted for as cash-settled share based compensation schemes:

	2017 £ million	2016 £ million
Share options – TSB Sharesave	**2.2**	0.3
Share grants – TSB Sustainable Performance Award	**2.8**	2.9
Other share based compensation schemes	**1.4**	0.2
	6.4	3.4

During 2017, TSB Group operated a Sharesave scheme and a Share Incentive Plan (SIP), both of which provide all TSB Group Partners with the opportunity to own shares in Sabadell, and the Sustainable Performance Award (SPA) scheme for more senior Partners. As all share-based compensation schemes involve an award of, or options over, Sabadell shares, these arrangements are accounted for as cash settled share-based payment arrangements resulting in the recognition of a liability. This liability is remeasured annually, with changes recognised in operating expenses, to reflect the latest Sabadell share price and the estimated number of shares expected to vest. At 31 December 2017 £10.1 million (2016: £6.6 million) was recognised in respect of share-based payments liability (see note 31).

Sustainable Performance Award (SPA)
The SPA is a discretionary long term incentive arrangement under which share grants vest between one and five years post grant (and between three and seven years post grant for certain senior executives) subject to the achievement of certain personal and corporate performance conditions. During 2017, 2,938,753 Sabadell shares (2016: 2,700,434 Sabadell shares), with a fair value, calculated using the market price at 31 December 2017, of £4.3 million (2016: £3.0 million), were awarded to certain senior Partners under the SPA. The carrying amount of the liability in respect of the SPA at 31 December 2017 was £6.3 million (2016: £5.5 million).

Sharesave scheme
Eligible Partners may choose to enter into a contract to save up to £500 per month and, at the maturity date, three years from the start of the savings contract, have the option to use these savings within six months to acquire shares in Sabadell at £0.7768, being a 20% discount to the average closing price and Sterling/Euro exchange rate on the date of the Sharesave invitation. Alternatively, eligible Partners may take the accumulated savings balance as a cash payment. Movements in the number of Sharesave options outstanding are set out below:

	2017		2016	
	Number of options (Sabadell) (000's)	**Weighted average exercise price (pence)**	Number of options (Sabadell) (000's)	Weighted average exercise price (pence)
Outstanding at 1 January	**13,974**	**77.68**	–	–
Granted	**–**	**–**	14,213	77.68
Exercised	**(65)**	**77.68**	–	–
Forfeited	**(554)**	**77.68**	(116)	77.68
Cancelled	**(354)**	**77.68**	(123)	77.68
Outstanding at 31 December	**13,001**	**77.68**	13,974	77.68
Exercisable at 31 December	**–**	**–**	–	–

The remaining contractual life of the options outstanding at 31 December 2017 was one year and nine months. At 31 December 2017, the fair value of the options, determined using a Black Scholes option pricing model, was 32.0 pence (2016: 29.7 pence) and a liability of £2.3 million (2016: £0.3 million) was recognised on the consolidated balance sheet.

Equity instruments designated at fair value through profit or loss
At 31 December 2017, £17.2 million (2016: £8.7 million) of Sabadell shares were held for the purpose of hedging TSB Group's obligations under the above share-based payment schemes. These equity instruments reduce the accounting mismatch arising from the volatility of marking to market the share-based payment liability and are designated at fair value through profit or loss on the consolidated balance sheet.

Notes to the consolidated financial statements

Charges (continued)

19. Taxation

	2017 £ million	2016 £ million
UK corporation tax		
Current tax on profit for the year	**(20.4)**	(28.6)
Adjustments in respect of prior year	**2.7**	0.1
Current tax charge	**(17.7)**	(28.5)
Deferred tax (note 20)		
Origination and reversal of temporary differences:		
Deferred tax on business transfers	**(23.8)**	(24.5)
Changes in UK corporation tax rates	**–**	(1.3)
Deferred tax on pension	**–**	0.2
Accelerated capital allowances	**1.7**	0.2
Adjustments in respect of prior years	**(4.2)**	–
Other	**–**	(0.3)
Deferred tax charge	**(26.3)**	(25.7)
Taxation charge	**(44.0)**	(54.2)

A reconciliation of the charge that would result from applying the UK corporation tax rate to profit before taxation to the actual taxation charge for the year is presented below:

	2017 £ million	2016 £ million
Profit before taxation	**162.7**	182.0
Taxation charge at applied UK corporation tax rate of 27.25% (2016: 28.0%)	**(44.3)**	(51.0)
Factors affecting charge:		
Disallowed costs	**(1.2)**	(4.0)
Non-taxable items	**1.0**	–
Changes to UK corporation tax rates	**–**	(1.3)
Taxable profits not subject to 8% bank surcharge	**2.0**	2.0
Adjustments in respect of prior years	**(1.5)**	0.1
Taxation charge	**(44.0)**	(54.2)

The applied UK corporation tax rate of 27.25% for 2017 includes the 8% bank surcharge on profits in excess of £25 million that was effective from 1 January 2016 together with the average UK corporation tax rate of 19.25%.

Disallowed costs primarily reflect certain recurring property and restructuring costs. Offsetting these is the non-taxable gain on TSB Group's investment in Sabadell shares used to satisfy its obligation under various share schemes and the effect of the non-applicability of the bank surcharge to the first £25 million of taxable profits.

Notes to the consolidated financial statements

Charges (continued)

20. Deferred tax assets

The movement in deferred tax assets is as follows:

	2017 £ million	2016 £ million
At 1 January	**99.6**	121.1
Income statement charge (note 19)	**(26.3)**	(25.7)
Amounts credited/(charged) to equity:		
Movements in cash flow hedging reserve	**–**	0.2
Movements in available-for-sale reserve	**(4.7)**	4.0
At 31 December	**68.6**	99.6

Deferred tax assets are comprised as follows:

	2017 £ million	2016 £ million
Deferred tax impact of business transfers	**78.2**	102.0
Revaluations of available-for-sale financial assets	**(7.0)**	(2.3)
Other temporary differences	**(2.6)**	(0.1)
Total deferred tax assets	**68.6**	99.6

Significant estimates - recoverability of deferred tax assets

At 31 December 2017, TSB Group recognised deferred tax assets of £68.6 million (2016: £99.6 million), primarily comprising £78.2 million in respect of temporary differences arising from the transfer of customer accounts during 2013 (2016: £99.5 million) which will unwind over the period to December 2021, being offset primarily by £7.0 million of a deferred tax liability arising from changes in the fair value of financial assets held as available-for-sale.

The valuation and assessment of the recovery of the deferred tax asset requires an estimate of the amount and timing of future taxable profits. TSB Group's expectations of the level of future taxable profits takes into account the Board approved medium term plan and associated risk factors including future economic outlook and regulatory change. Based on this, management have concluded it remains appropriate to recognise the deferred tax asset in full.

Notes to the consolidated financial statements

Profits and returns to the shareholder

The Board reviews TSB Group's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB Group faces, or returned to the shareholder in the form of dividends. Currently all returns are being reinvested in the business.

Accounting policies relevant to profits and returns to the shareholder

(i) Share capital

Shares are classified as equity instruments when there is no contractual obligation to deliver cash or other assets to another entity on terms that may be unfavourable. Ordinary shares are classified as equity.

21. Shareholder's equity

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profits £ million
Balance at 1 January 2016	5.0	965.1	616.5	(1,311.6)	410.0	16.3	(0.9)	1,045.9
Net movement in available-for-sale reserve	–	–	–	–	–	(10.4)	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	–	1.3	–
Profit for the year	–	–	–	–	–		–	127.8
At 31 December 2016	5.0	965.1	616.5	(1,311.6)	410.0	5.9	0.4	1,173.7
Balance at 1 January 2017	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**5.9**	**0.4**	**1,173.7**
Net movement in available-for-sale reserve	**–**	**–**	**–**	**–**	**–**	**12.8**	**–**	**–**
Net movement in cash flow hedging reserve	**–**	**–**	**–**	**–**	**–**	**–**	**(0.9)**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**118.7**
At 31 December 2017	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**18.7**	**(0.5)**	**1,292.4**

At 31 December 2017, TSB Banking Group plc had in issue 500.0 million (2016: 500.0 million) one pence ordinary shares authorised, allotted and fully paid up.

In 2014 TSB Banking Group plc was incorporated with 50,000 ordinary £1 shares. During 2014, this increased to 500.0 million one pence ordinary shares as a result of the following:

- a 100 for 1 share split which increased the number of shares to 5.0 million.
- a share issuance of 50 million one pence ordinary shares in exchange for the acquisition of the entire share capital of TSB Bank plc. The issuance was recorded at the carrying amount of the net assets of TSB Bank plc at the date of acquisition and resulted in a transfer to the share premium reserve of a minimum amount required by the Companies Act 2016. The difference between the amount transferred to share capital and share premium and the carrying amount of the net assets of TSB Bank plc was transferred to the merger reserve. The capital reorganisation reserve was established as a result of the incorporation of TSB Banking Group plc and also includes the impact of this issuance.
- a share issuance of 445.0 million one pence ordinary shares at a premium of £0.4394 per share to its then immediate parent company, Lloyds Bank plc, for cash proceeds of £200.0 million.

The capital reserve represents a capital contribution received in 2013 from a, then, parent company.

The capital reorganisation reserve was established in 2014 to reflect the effect of TSB Banking Group plc becoming the new holding company of the TSB Group by means of the share for share exchange.

The available-for-sale reserve represents the unrealised change in the fair value of available-for-sale investments since initial recognition.

The cash flow hedging reserve represents the cumulative gains and losses on effective cash flow hedging instruments that will be recycled to the income statement when the hedged transactions affect profit or loss.

Notes to the consolidated financial statements

Managing financial risk

Financial instruments are fundamental to TSB Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by TSB. The primary risks affecting TSB Group through its use of financial instruments are: credit risk; liquidity risk; and market risk. A summary of TSB Group's use of financial instruments and information about the management of these risks is presented below.

Accounting policies relevant to managing financial risk

(j) Derivative financial instruments and hedge accounting

All derivative financial instruments are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow as appropriate. Derivatives are carried on the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative.

Changes in the fair value of any derivative instrument are recognised immediately in the income statement.

Fair value is the exit price from the perspective of market participants who hold the asset or owe the liability at the measurement date.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value of the hedged risk. In its application of the hedge accounting policy, TSB Group follows the requirements of the EU – endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* adopted by the EU which are not available in the version issued by the IASB, specifically relating to hedging core deposits. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued. TSB Group designates certain derivatives as either hedges of the fair value of recognised assets or liabilities (fair value hedges) or hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges).

Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using a straight line method over the period to maturity.

Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedging reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the previously hedged cash flow is ultimately recognised in the income statement.

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Measurement basis of financial instruments

The following tables analyse the carrying amounts of financial instruments by category.

At 31 December 2017	Fair value through profit or loss £ million	Available-for- sale £ million	Held at amortised cost £ million	Designated as hedging instruments £ million	Loans and receivables £ million	Total £ million
Financial liabilities						
Derivative financial liabilities	**37.5**	**–**	**–**	**566.5**	**–**	**604.0**
Financial liabilities at amortised cost:						
Deposits from central banks	**–**	**–**	**5,625.7**	**–**	**–**	**5,625.7**
Customer deposits	**–**	**–**	**30,520.6**	**–**	**–**	**30,520.6**
Repurchase agreements	**–**	**–**	**1,446.4**	**–**	**–**	**1,446.4**
Debt securities in issue	**–**	**–**	**1,318.7**	**–**	**–**	**1,318.7**
Subordinated liabilities	**–**	**–**	**405.3**	**–**	**–**	**405.3**
Other financial liabilities	**–**	**–**	**247.3**	**–**	**–**	**247.3**
Total financial liabilities	**37.5**	**–**	**39,564.0**	**566.5**	**–**	**40,168.0**
Financial assets						
Cash, cash balances at central banks and other demands deposits	**–**	**–**	**7,563.8**	**–**	**–**	**7,563.8**
Trading derivative financial assets	**111.1**	**–**	**–**	**103.7**	**–**	**214.8**
Equity instruments designated at FVTPL	**17.2**	**–**	**–**	**–**	**–**	**17.2**
Available-for-sale financial assets		**2,123.3**	**–**	**–**	**–**	**2,123.3**
Loans and receivables:						
Loans to central banks	**–**	**–**	**–**	**–**	**56.0**	**56.0**
Loans to credit institutions	**–**	**–**	**–**	**–**	**329.2**	**329.2**
Loans and advances to customers	**–**	**–**	**–**	**–**	**30,854.2**	**30,854.2**
Other advances	**–**	**–**	**–**	**–**	**896.0**	**896.0**
Total financial assets	**128.3**	**2,123.3**	**7,563.8**	**103.7**	**32,135.4**	**42,054.5**
At 31 December 2016						
Financial liabilities						
Derivative financial liabilities	97.7	–	–	529.1	–	626.8
Financial liabilities at amortised cost:						
Deposits from central banks	–	–	5.0	–	–	5.0
Deposits from credit institutions	–	–	2.3	–	–	2.3
Repurchase agreements	–	–	1,409.6	–	–	1,409.6
Customer deposits	–	–	29,383.8	–	–	29,383.8
Debt securities in issue	–	–	2,940.1	–	–	2,940.1
Subordinated liabilities	–	–	413.3	–	–	413.3
Other financial liabilities	–	–	228.6	–	–	228.6
Total financial liabilities	97.7	–	34,382.7	529.1	–	35,009.5
Financial assets						
Cash, cash balances at central banks and other demands deposits	–	–	3,647.7	–	–	3,647.7
Derivative financial assets	143.2	–	–	104.3	–	247.5
Equity instruments designated at FVTPL	8.7	–	–	–	–	8.7
Available-for-sale financial assets:		2,103.5	–	–	–	2,103.5
Loans and receivables:						
Loans and advances to central banks	–	–	–	–	51.0	51.0
Loans and advances to credit institutions	–	–	–	–	530.5	530.5
Loans and advances to customers	–	–	–	–	29,419.1	29,419.1
Other advances	–	–	–	–	799.0	799.0
Total financial assets	151.9	2,103.5	3,647.7	104.3	30,799.6	36,807.0

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk

Credit risk is the risk of financial loss if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, and includes the use of various credit risk rating systems to measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the exposure to the counterparty at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. TSB Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales. TSB Group's credit risk exposure, which arises primarily in the United Kingdom, is set out below.

(i) Maximum credit exposure

The maximum credit risk exposure in the event of other parties failing to perform their obligations is presented below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions, their contractual nominal amounts.

	2017 £ million	2016 £ million
Loans to central banks	**56.0**	51.0
Loans to credit institutions	**329.2**	530.5
Loans and advances to customers [(1)]	**30,854.2**	29,419.1
Available-for-sale financial assets	**2,116.3**	2,098.3
Other advances (excluding collateral)	**260.4**	220.4
Derivative financial assets	**214.8**	247.5
	33,830.9	32,566.8
Lending commitments – revocable	**3,399.7**	3,498.7
Lending commitments – irrevocable	**1,282.9**	1,778.3
Maximum credit risk exposure	**38,513.5**	37,843.8

(1) Amounts shown are net of related impairment allowances.

(ii) Credit quality of assets

Loans and receivables

The analysis of lending between mortgages, other loans and advances to customers and other loans and receivables has been presented based upon the type of exposure.

	Loans and advances to customers			Other loans and receivables[(1)]
At 31 December 2017	Mortgages £ million	Unsecured lending and business banking £ million	Total £ million	£ million
Neither past due nor impaired	**27,988.5**	**2,425.2**	**30,413.7**	**385.2**
Past due but not impaired	**323.8**	**34.2**	**358.0**	**–**
Impaired – no provision required	**46.3**	**27.1**	**73.4**	**–**
Impaired - provision held	**35.1**	**45.6**	**80.7**	**–**
Gross loans and receivables	**28,393.7**	**2,532.1**	**30,925.8**	**385.2**
Allowance for impairment losses (note 9)	**(25.7)**	**(45.9)**	**(71.6)**	**–**
Net loans and receivables	**28,368.0**	**2,486.2**	**30,854.2**	**385.2**
At 31 December 2016				
Neither past due nor impaired	26,645.3	2,254.6	28,899.9	581.5
Past due but not impaired	417.1	35.8	452.9	–
Impaired - no provision required	57.9	–	57.9	–
Impaired - provision held	31.8	50.3	82.1	–
Gross loans and receivables	27,152.1	2,340.7	29,492.8	581.5
Allowance for impairment losses (note 9)	(28.0)	(45.7)	(73.7)	–
Net loans and receivables	27,124.1	2,295.0	29,419.1	581.5

(1) Other loans and receivables comprise loans to central banks and loans to credit institutions.

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk (continued)

Loans and receivables which are neither past due nor impaired

31 December 2017	Loans and advances to customers: Mortgages £ million	Loans and advances to customers: Unsecured lending and business banking £ million	Loans and advances to customers: Total £ million	Other loans and receivables £ million
Good quality	**27,939.2**	**2,108.6**	**30,047.8**	**385.2**
Satisfactory quality	**41.3**	**252.8**	**294.1**	**–**
Lower quality	**5.1**	**30.4**	**35.5**	**–**
Below standard, but not impaired	**2.9**	**33.4**	**36.3**	**–**
Total loans and receivables which are neither past due nor impaired	**27,988.5**	**2,425.2**	**30,413.7**	**385.2**
31 December 2016				
Good quality	26,605.2	1,964.6	28,569.8	581.5
Satisfactory quality	33.0	237.0	270.0	–
Lower quality	2.9	25.5	28.4	–
Below standard, but not impaired	4.2	27.5	31.7	–
Total loans and receivables which are neither past due nor impaired	26,645.3	2,254.6	28,899.9	581.5

The above classifications reflect expected recovery levels as well as probabilities of default assessed using internal rating models. Good quality lending includes all the lower assessed default probabilities and all loans and receivables with low expected losses in the event of a default, with other categories reflecting progressively higher risks and lower expected recoveries.

Available-for-sale financial assets include gilts and supranational and development bank bonds rated at least AA.

Loans and receivables which are past due but not impaired

31 December 2017	Loans and advances to customers: Mortgages £ million	Loans and advances to customers: Unsecured lending and business banking £ million	Loans and advances to customers: Total £ million	Other loans and receivable £ million
0-30 days	**158.8**	**19.5**	**178.3**	**–**
30-60 days	**53.8**	**8.5**	**62.3**	**–**
60-90 days	**40.7**	**0.1**	**40.8**	**–**
90-180 days	**50.0**	**0.2**	**50.2**	**–**
Over 180 days	**20.5**	**5.9**	**26.4**	**–**
Total loans and receivables which are past due but not impaired	**323.8**	**34.2**	**358.0**	**–**
31 December 2016				
0-30 days	180.1	21.3	201.4	–
30-60 days	83.6	7.1	90.7	–
60-90 days	55.7	0.1	55.8	–
90-180 days	66.6	0.3	66.9	–
Over 180 days	31.1	7.0	38.1	–
Total loans and receivables which are past due but not impaired	417.1	35.8	452.9	–

A financial asset is past due if a counterparty has failed to make a payment when contractually due.

An analysis of derivative financial assets is presented in note 26. Derivative financial instruments are collateralised, in the majority of cases, via a central clearing house which mitigates credit risk arising from these financial instruments.

Managing financial risk (continued)

23. Credit risk (continued)

(iii) Collateral held as security for financial assets

TSB Group holds collateral against loans and advances to customers in the form of mortgages over residential property and second charges over business assets, including commercial and residential property.

Mortgages

An analysis by loan-to-value (LTV) ratio of TSB Group's residential mortgage lending is presented below. The value of collateral used in determining the LTV ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices.

31 December 2017	Neither past due nor impaired £ million	Past due but not impaired £ million	Impaired £ million	Gross £ million
Less than 70%	**20,158.1**	**223.2**	**48.8**	**20,430.1**
70% to 80%	**4,851.8**	**48.9**	**14.5**	**4,915.2**
80% to 90%	**2,367.0**	**32.3**	**9.4**	**2,408.7**
90% to 100%	**553.9**	**10.8**	**5.9**	**570.6**
Greater than 100%	**57.7**	**8.6**	**2.8**	**69.1**
Total mortgages	**27,988.5**	**323.8**	**81.4**	**28,393.7**
31 December 2016				
Less than 70%	19,671.7	275.5	58.1	20,005.3
70% to 80%	4,020.8	65.2	11.8	4,097.8
80% to 90%	2,215.1	42.0	8.8	2,265.9
90% to 100%	651.9	23.5	7.1	682.5
Greater than 100%	85.8	10.9	3.9	100.6
Total mortgages	26,645.3	417.1	89.7	27,152.1

Unsecured lending and business banking

At 31 December 2017, unimpaired unsecured and business banking lending amounted to £2,485.5 million (2016: £2,290.4 million). At 31 December 2017, impaired unsecured and business banking lending amounted to £0.7 million (2016: £4.6 million), net of an impairment allowance of £45.9 million (2016: £45.7 million). Non-mortgage retail lending is unsecured, with no collateral held in respect of retail credit cards, overdrafts, or unsecured personal loans.

For business banking lending, collateral primarily consists of second charges over commercial and residential property. Where collateral is held, lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on any collateral provided. Collateral values are assessed at the time of loan origination and reassessed if there is observable evidence of distress of the borrower. At 31 December 2017, credit risk is mitigated by collateral held totalling £159.1 million (2016: £137.7 million).

(iv) Collateral repossessed

	2017 £ million	2016 £ million
Residential property	**6.1**	3.7
Total collateral repossessed	**6.1**	3.7

TSB Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

(v) Forbearance

TSB Group operates a number of schemes to assist borrowers who are experiencing financial difficulties. Forbearance solutions may offer relief in the form of reductions to contractual payments, and for customers who have longer term financial difficulties, term extensions and 'repair' approaches such as capitalisation of arrears. At 31 December 2017, total forborne loans were £363.1 million (2016: £371.1 million), of which £59.2 million (2016: £67.0 million) were impaired. At 31 December 2017, the allowance for loan losses held in respect of forborne loans was £13.2 million (2016: £15.3 million).

Managing financial risk (continued)

24. Liquidity risk

Definition and exposure

Liquidity risk is the risk that TSB Group is unable to meet its liabilities as they fall due, or is unable to maintain regulator, investor, customer or stakeholder confidence that this will be achieved. Liquidity exposure represents the mismatch of potential outflows in any future period measured against expected inflows. Liquidity risk is managed, monitored and measured from both an internal and regulatory perspective.

Sources of funding

TSB Group's funding and liquidity position is underpinned by its significant customer deposit base. The deposit base is made up of customer current and savings accounts which, although mostly repayable on demand, have historically provided a stable source of funding. TSB Group has also diversified its funding base further during 2017 through issuance of covered bonds, and accessing funding under the Bank of England's Term Funding Scheme. Further information regarding sources of funding is available on pages 16 to 18. At 31 December 2017, TSB Group's primary liquidity portfolio totalled £9,536.2 million (2016: £5,571.4 million). This comprised £7,419.9 million (2016: £3,473.1 million) held on deposit with the Bank of England, a £1,721.5 million (2016: £1,872.8 million) portfolio of UK gilts (of which £1,444.7 million (2016: £662.8 million) had been sold under repurchase agreements – see note 4) and £394.8 million (2016: £225.5 million) of supranational and development bank bonds.

Risk appetite

The funding and liquidity risk appetite for TSB Group is set and approved annually by the Board. Risk is reported against this appetite through various metrics to enable TSB Group to manage the funding and liquidity position. The risk appetite is established under a liquidity risk management framework designed with the aim that TSB Group has sufficient financial resources of appropriate quality.

Measurement and monitoring

A series of measures are used across TSB Group to monitor both short term and long term liquidity. Liquidity is measured on a daily basis and reported internally. Daily liquidity reporting is supplemented by early warning indicators and a Liquidity Contingency Plan. Monthly reporting procedures are in place to update and inform senior management. All liquidity policies and procedures are subject to periodic independent internal oversight.

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

The table below presents the contractual residual maturities of the assets and liabilities on the balance sheet:

At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5,625.7	–	–	–	–	5,625.7
Deposits from credit institutions	–	–	–	–	–	–
Repurchase agreements	1,446.4	–	–	–	–	1,446.4
Customer deposits	26,680.8	669.7	2,087.8	1,082.3	–	30,520.6
Debt securities in issue	–	62.6	144.1	1,112.0	–	1,318.7
Subordinated liabilities	17.8	–	3.4	384.1	–	405.3
Other financial liabilities	247.3	–	–	–	–	247.3
Trading derivative liabilities	0.3	0.9	4.7	24.4	7.2	37.5
Hedging derivative liabilities	–	–	3.2	19.4	543.9	566.5
Other liabilities (1)	320.5	0.1	(2.7)	9.5	34.5	361.9
Total liabilities	**34,338.8**	**733.3**	**2,240.5**	**2,631.7**	**585.6**	**40,529.9**

(1) Other liabilities comprise current tax liabilities, provisions, fair value adjustments for portfolio hedged risk and other liabilities.

Assets						
Loans and receivables:						
Loans to central banks	56.0	–	–	–	–	56.0
Loans to credit institutions	–	205.1	–	124.1	–	329.2
Loans and advances to customers	1,094.8	260.8	1,320.4	5,987.4	22,190.8	30,854.2
Other advances	896.0	–	–	–	–	896.0
Available-for-sale financial assets	–	–	–	–	2,123.3	2,123.3
Trading derivative assets	0.2	0.6	10.9	66.1	33.3	111.1
Hedging derivative assets	–	–	1.3	96.1	6.3	103.7
Other assets (2)	7,805.6	–	10.9	57.7	177.8	8,052.0
Total assets	**9,852.6**	**466.5**	**1,343.5**	**6,331.4**	**24,531.5**	**42,525.5**

(2) Other assets comprise cash, cash balances at central banks and other demand deposits, equity instruments, fair value adjustments for portfolio hedged risk, property, plant and equipment, intangible assets, deferred tax assets and other assets.

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

At 31 December 2016	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5.0	–	–	–	–	5.0
Deposits from credit institutions	2.3	–	–	–	–	2.3
Customer deposits	25,296.7	266.2	1,054.7	2,766.2	–	29,383.8
Repurchase agreements	659.6	–	750.0	–	–	1,409.6
Debt securities in issue	–	159.9	507.9	2,272.3	–	2,940.1
Subordinated liabilities	26.1	3.4	–	–	383.8	413.3
Other financial liabilities	228.6	–	–	–	–	228.6
Trading derivative liabilities	0.1	0.4	14.1	77.7	5.4	97.7
Hedging derivative liabilities	–	–	0.4	9.3	519.4	529.1
Other liabilities	216.9	0.4	(1.5)	16.3	89.1	321.2
Total liabilities	26,435.3	430.3	2,325.6	5,141.8	997.7	35,330.7
Assets						
Loans and receivables:						
Loans to central banks	51.0	–	–	–	–	51.0
Loans to credit institutions	–	334.2	–	196.3	–	530.5
Loans and advances to customers	1,194.5	272.0	1,229.7	5,609.7	21,113.2	29,419.1
Other advances	799.0	–	–	–	–	799.0
Available-for-sale financial assets	–	–	–	–	2,103.5	2,103.5
Trading derivative assets	0.4	0.7	8.2	110.4	23.5	143.2
Hedging derivative assets	–	(0.4)	–	84.9	19.8	104.3
Other assets	3,713.0	–	19.7	79.8	232.6	4,045.1
Total assets	5,757.9	606.5	1,257.6	6,081.1	23,492.6	37,195.7

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

Contractual maturities for financial liabilities form an important source of information for the management of liquidity risk. The table below analyses financial liabilities by relevant contractual maturity grouping on an undiscounted future cash flow basis based on the remaining period at the balance sheet date.

At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	**5,625.7**	**–**	**–**	**–**	**–**	**5,625.7**
Deposits from credit institutions	**–**	**–**	**–**	**–**	**–**	**–**
Customer deposits	**26,679.4**	**680.0**	**2,120.0**	**1,099.0**	**–**	**30,578.4**
Repurchase agreements	**1,296.2**	**–**	**150.2**	**–**	**–**	**1,446.4**
Debt securities in issue	**–**	**52.6**	**148.9**	**1,080.0**	**–**	**1,281.5**
Subordinated liabilities	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
Other financial liabilities	**247.3**	**–**	**–**	**–**	**–**	**247.3**
Total non-derivative financial liabilities	**33,848.6**	**732.6**	**2,441.2**	**2,619.3**	**–**	**39,641.7**
Gross settled derivative - outflows	**16.7**	**16.8**	**161.3**	**753.4**	**605.9**	**1,554.1**
Gross settled derivative - inflows	**(15.6)**	**(12.6)**	**(87.8)**	**(591.3)**	**(271.1)**	**(978.4)**
Total financial liabilities	**33,849.7**	**736.8**	**2,514.7**	**2,781.4**	**334.8**	**40,217.4**

At 31 December 2016	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5.0	–	–	–	–	5.0
Deposits from credit institutions	2.3	–	–	–	–	2.3
Customer deposits	25,292.9	218.0	1,126.7	2,887.7	–	29,525.3
Repurchase agreements	658.6	2.9	756.8	–	–	1,418.3
Debt securities in issue	–	163.6	526.8	2,297.1	–	2,987.5
Subordinated liabilities	–	–	22.1	462.5	–	484.6
Other financial liabilities	228.6	–	–	–	–	228.6
Total non-derivative financial liabilities	26,187.4	384.5	2,432.4	5,647.3	–	34,651.6
Gross settled derivative - outflows	31.4	24.7	191.1	715.1	472.1	1,434.4
Gross settled derivative - inflows	(18.6)	(10.7)	(80.3)	(501.9)	(213.6)	(825.1)
Total financial liabilities	26,200.2	398.5	2,543.2	5,860.5	258.5	35,260.9

25. Capital resources

TSB Group maintains a strong capital base which has met regulatory requirements under the Capital Requirements Regulation and which seeks to support the growth of the business, even under stressed conditions. The table below presents TSB Group's regulatory capital resources.

	2017 £ million	2016 £ million
Shareholder's equity	**1,995.6**	1,865.0
Regulatory deductions	**(97.5)**	(79.6)
Common Equity Tier 1/Total Tier 1 capital	**1,898.1**	1,785.4
Tier 2 capital	**384.1**	383.9
Total capital resources	**2,282.2**	2,169.3

Further information on capital resources is available on pages 16 to 18 in the review of our performance in 2017.

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk

Definition and exposure

Market risk is the risk of a reduction in earnings, value or reserves caused by changes in the prices of financial instruments. TSB Group's market risk consists primarily of exposure to changes in interest rates. Interest rate risk is the risk that the net value of, or net income arising from, the firm's assets and liabilities is impacted as a result of changes to interest rates. Interest rate risk can arise as a result of changes in customer behaviour, which may affect the maturity profiles of TSB Group's assets and liabilities. TSB Group's exposure to changes in interest rates includes the margin between customer and market rates. This includes the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets.

Management and measurement

Risk exposure across TSB Group is monitored monthly using, primarily, net interest income and earnings sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in net interest income that would result from a set of defined interest rate shocks. A limit structure exists to ensure that risks stemming from residual positions or from changes in assumptions about customer behaviour remain within risk appetite.

A 12 month view of the sensitivity of net interest income is calculated on the basis of TSB Group's current consolidated balance sheet with re-pricing dates adjusted according to behavioural assumptions. At 31 December 2017, the projected change in 12 month net interest income in response to an immediate parallel shift in all relevant interest rates, market and administered, would be an increase of 10.2 million (2016: £9.4 million) from a 25bps increase in rates, and a decrease of £18.3 million (2016: £19.7 million) from a 25bps decrease. The measure assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount and does not take into account potential management actions.

Derivative financial instruments

TSB Group holds derivative financial instruments in the normal course of its banking business for interest rate risk management and margin stabilisation purposes. Derivatives are recognised at fair value on TSB Group's consolidated balance sheet. The fair values and notional amounts of derivative instruments are presented in the following table:

	2017			2016		
	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million
Interest rate swaps	**21,069.7**	**104.2**	**(37.5)**	19,722.5	139.9	(97.7)
Equity options	**8.7**	**6.9**	**–**	8.7	3.3	–
Trading derivative instruments	**21,078.4**	**111.1**	**(37.5)**	19,731.2	143.2	(97.7)
Designated as micro fair value hedges	**4,631.9**	**21.5**	**(2.1)**	845.0	26.3	(1.1)
Designated as macro fair value hedges	**9,036.9**	**17.4**	**(564.4)**	4,673.7	21.7	(528.0)
Designated as cash flow hedges	**348.4**	**64.8**	**–**	372.1	56.3	–
Hedging derivative instruments	**14,017.2**	**103.7**	**(566.5)**	5,890.8	104.3	(529.1)
Total derivative instruments	**35,095.6**	**214.8**	**(604.0)**	25,622.0	247.5	(626.8)

Derivative assets of £201.8 million (2016: £238.6 million) are expected to be recovered after more than one year. Derivative liabilities of £594.9 million (2016: £611.8 million) are expected to be settled after more than one year.

Gains/(losses) from hedge accounting

TSB Group recognised gains from hedge accounting as follows:

	2017 £ million	2016 £ million
Fair value hedges	**24.5**	17.1
Cash flows hedges	**–**	3.6
Gains from hedge accounting	**24.5**	20.7

Fair value hedges

TSB Group designates certain of its fixed rate customer loans, debt securities, customer deposits and subordinated debt in fair value hedge accounting relationships. During the year gains of £55.4 million (2016: losses of £40.8 million) were recognised on derivatives in hedge accounting relationships and losses of £63.5 million (2016: gains of £37.2 million) were recognised on the hedged items attributable to the hedged interest rate risk resulting in fair value hedge ineffectiveness losses of £8.1 million (2016: losses of £3.6 million). Gains from hedge accounting also includes other hedge accounting adjustments of £32.6 million (2016: £20.7 million) reflect the amortisation of hedge adjustments in respect of previous fair value hedges relationships that have been de-designated.

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

Cash flow hedges

TSB Group uses cash flow hedge accounting relationships for interest rate and foreign exchange risk and designates certain of its base rate mortgages and debt securities in issue in qualifying cash flow hedge accounting relationships. During the year, gains of £9.3 million (2016: £47.0 million) were transferred from the cash flow hedging reserve to other operating income, no gains were transferred to net interest income in 2017 (2016: £0.5 million).

In 2017, no gains were recognised in other operating income in respect of ineffectiveness arising from cash flow hedges (2016: £3.6 million).

The following tables present the periods when TSB Group's hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges.

At 31 December 2017	Less than 1 year £ million	1-2 years £ million	2-3 years £ million	3-4 years £ million	4-5 years £ million	5-10 years £ million	Total £ million
Hedged forecast cash flows expected to occur:							
Forecast receivable cash flows	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Forecast payable cash flows	**(34.9)**	**(32.0)**	**(284.6)**	**–**	**–**	**–**	**(351.5)**
Hedged forecast cash flows affect profit or loss:							
Forecast receivable cash flows	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Forecast payable cash flows	**(0.5)**	**(1.1)**	**(1.4)**	**–**	**–**	**–**	**(3.0)**

At 31 December 2016	Less than 1 year £ million	1-2 years £ million	2-3 years £ million	3-4 years £ million	4-5 years £ million	5-10 years £ million	Total £ million
Hedged forecast cash flows expected to occur:							
Forecast receivable cash flows	–	–	–	–	–	–	–
Forecast payable cash flows	(37.1)	(33.8)	(30.9)	(273.6)	–	–	(375.4)
Hedged forecast cash flows affect profit or loss:							
Forecast receivable cash flows	–	–	–	–	–	–	–
Forecast payable cash flows	(0.6)	(0.7)	(1.0)	(1.0)	–	–	(3.3)

During 2017 and 2016 there were no transactions for which cash flow hedge accounting had to be ceased as a result of the highly probable cash flows no longer being expected to occur.

Offsetting financial assets and financial liabilities

The following information relates to financial assets and liabilities which have not been set off but for which TSB Group has enforceable master netting agreements in place with counterparties.

				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2017	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related financial instrument amounts not offset £ million	Cash collateral received/ pledged[1] £ million	Potential net amount £ million
Derivative financial assets	**214.8**	**–**	**214.8**	**(143.1)**	**(6.9)**	**64.8**
Total assets	**214.8**	**–**	**214.8**	**(143.1)**	**(6.9)**	**64.8**
Derivative financial liabilities	**(604.0)**	**–**	**(604.0)**	**143.1**	**460.4**	**(0.5)**
Repurchase agreements	**(1,446.4)**	**–**	**(1,446.4)**	**1,444.7**	**1.7**	**–**
Total liabilities	**(2,050.4)**	**–**	**(2,050.4)**	**1,587.8**	**462.1**	**(0.5)**
At 31 December 2016[2]						
Derivative financial assets	247.5	–	247.5	(187.9)	(3.3)	56.3
Total assets	247.5	–	247.5	(187.9)	(3.3)	56.3
Derivative financial liabilities	(626.8)	–	(626.8)	187.9	438.9	–
Repurchase agreements	(1,409.6)	–	(1,409.6)	1,409.6	–	–
Total liabilities	(2,036.4)	–	(2,036.4)	1,597.5	438.9	–

(1) Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value and this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation.
(2) Amounts have been re-presented to be consistent with current year presentation.

Accounting policies relevant to this section

(k) Provisions and contingent liabilities
Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

Contingent assets are possible assets that arise from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within TSB Group's control. These are disclosed where an inflow of economic benefits is probable, and are recognised only when it is virtually certain that an inflow of economic benefits will arise.

(l) Property, plant and equipment
Property, plant and equipment are recognised at cost less accumulated depreciation. Cost includes the original purchase price of the assets and the costs attributable to bringing the asset into working condition for its intended use. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease.
- Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease.

Equipment:

- Fixtures and furnishings: 0-10 years.
- Other equipment and motor vehicles: 2-8 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset’s carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset’s fair value less costs to sell and its value in use.

(m) Operating leases
The leases entered into by TSB Group as lessee are operating leases. Operating lease rentals payable are charged to the income statement on a straight-line basis over the period of the lease. When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

Notes to the consolidated financial statements

Other important disclosures (continued)

27. Contingent liabilities

(i) The Financial Services Compensation Scheme (FSCS)
The FSCS is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. Although the substantial majority of the remaining loan balance is expected to be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets, any shortfall and interest cost will be funded by deposit-taking participants of the FSCS.

During 2017, TSB Group has paid, as required, its share of the 2016/17 interest and accrued for its share of the 2017/18 interest element, payable in September 2018.

The amount of future compensation costs levies payable by TSB Group depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants and any shortfall in the repayment of the loan from HM Treasury.

(ii) Legal and regulatory matters
During the ordinary course of business, TSB Group may be subject to other actual or potential legal proceedings (which may include class action lawsuits brought on behalf of customers and other third parties), regulatory investigations, regulatory challenges and enforcement actions. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of TSB Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed to properly assess the merits of the case and no provisions are held against such matters. However, TSB Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

28. Related party transactions

TSB Group's related parties include key management personnel, Sabadell and other Sabadell Group companies.

(i) Key management personnel
Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of TSB Group which is the Board and Executive Committee. The compensation paid or payable to key management personnel is shown in the table below.

	2017 £ 000	2016 £ 000
Short term Partner benefits	**7,500**	7,144
Post-employment benefits	**892**	880
Other long term benefits	**4,645**	1,340
Share-based payments	**1,333**	2,430
Payments for loss of office	**30**	14
Total	**14,400**	11,808

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Related party transactions (continued)

The tables below detail, on an aggregated basis, related party transactions, balances outstanding at the year end and related income and expense in respect of key management personnel.

	2017 £ 000	2016 £ 000
Loans		
At 1 January	**211**	262
Advances (includes key management personnel appointed during the year)	**242**	254
Interest charged during the year	**5**	8
Repayments (includes key management personnel who resigned during the year)	**(220)**	(313)
At 31 December	**238**	211

The loans attracted interest at customer rates and were made in the ordinary course of business. No provisions have been recognised in respect of loans given to key management personnel (2017: £nil).

	2017 £ 000	2016 £ 000
Deposits		
At 1 January	**819**	1,161
Deposits (includes key management personnel appointed during the year)	**4,892**	3,567
Interest expense on deposits	**–**	1
Repayments (includes key management personnel who resigned during the year)	**(4,371)**	(3,910)
At 31 December	**1,340**	819

All deposits placed by key management personnel are at customer rates and were made in the ordinary course of business.

(ii) Transactions and balances with Sabadell Group companies

During 2016, TSB Bank plc and its ultimate parent company, Banco Sabadell, confirmed a set of arrangements between themselves which restricts the aggregate financial exposure of the IT Migration Programme to TSB Bank plc to a maximum of £15 million. As a consequence, at 31 December 2017 TSB Group deferred £124.5 million (2016: £37.0 million) of IT Migration Programme costs incurred to date as a prepayment of charges for services from a Sabadell Group company that will crystallise on the completion of the migration from the existing LBG platform.

TSB Group holds options purchased in 2016 from Sabadell to acquire 11.2 million Sabadell shares at an exercise price of 77.68p in order to hedge the risk associated with the TSB Sharesave scheme. At 31 December 2017, the options had a fair value of £6.9 million (2016: £3.3 million) and Sabadell had placed cash collateral with TSB Group of £7.3 million. (2016: £3.8 million).

Sabadell was appointed as a Joint Lead Manager in relation to TSB Group's first covered bond issue, which completed in December 2017, and received a fee of £0.3 million for the services provided to TSB Group.

Notes to the consolidated financial statements

Other important disclosures (continued)

29. Property, plant and equipment

	Premises £ million	Equipment £ million	Total £ million
Cost			
At 1 January 2016	189.3	90.6	279.9
Additions	28.2	7.7	35.9
Disposals	(2.1)	(0.6)	(2.7)
Write-offs	(5.0)	(3.2)	(8.2)
At 31 December 2016	**210.4**	**94.5**	**304.9**
Additions	**26.3**	**11.1**	**37.4**
Disposals	**(4.3)**	**–**	**(4.3)**
Write-offs	**(3.6)**	**(3.4)**	**(7.0)**
At 31 December 2017	**228.8**	**102.2**	**331.0**
Accumulated depreciation			
At 1 January 2016	66.9	51.9	118.8
Depreciation charge for the year (note 16)	14.9	8.2	23.1
Disposals	(0.4)	(0.3)	(0.7)
Write-offs	(2.4)	(2.2)	(4.6)
At 31 December 2016	**79.0**	**57.6**	**136.6**
Depreciation charge for the year (note 16)	**16.8**	**10.7**	**27.5**
Disposals	**(2.2)**	**–**	**(2.2)**
Write-offs	**(1.3)**	**(2.3)**	**(3.6)**
At 31 December 2017	**92.3**	**66.0**	**158.3**
Carrying amount			
At 31 December 2017	**136.5**	**36.2**	**172.7**
At 31 December 2016	131.4	36.9	168.3

At 31 December 2017, there was no capital expenditure authorised and contracted for but not provided or incurred (2016: £0.1 million).

Operating lease commitments

Where TSB Group is the lessee, the future minimum lease payments under non-cancellable premises operating leases are as follows:

	2017 £ million	2016 £ million
Not later than 1 year	**32.4**	32.0
Later than 1 year and no later than 5 years	**100.1**	105.2
Later than 5 years	**85.3**	77.7
Total operating lease commitments	**217.8**	214.9

Operating lease payments represent rental payable by TSB Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

30. Other assets

	2017 £ million	2016 £ million
Prepaid migration costs	**124.5**	37.0
Other assets and prepayments	**83.1**	68.6
Amounts recoverable under customer remediation indemnity (note 31)	**34.2**	11.8
Total other assets	**241.8**	117.4

As discussed in Note 28(ii) on page 103, TSB Group deferred £124.5 million (2016: £37.0 million) of IT Migration Programme costs incurred to date as a prepayment of charges for services from Sabadell Group that will crystallise on the completion of the final phase of the Migration Programme.

Notes to the consolidated financial statements

Other important disclosures (continued)

31. Other liabilities and provisions

	2017 £ million	2016 £ million
Accruals and deferred income	**216.8**	152.8
Share-based payments liability	**10.1**	6.6
Other creditors	**51.5**	65.6
Total other liabilities	**278.4**	225.0

	2017 £ million	2016 £ million
Customer remediation provision	**34.5**	10.8
Total provision	**34.5**	10.8

Significant estimates – customer remediation provision

TSB Group is protected from losses arising from historic misconduct under an indemnity provided by Lloyds Bank plc. However, TSB Group retains the primary liability for the alleged misconduct to its customers and a provision for customer remediation of £34.5 million has been recognised at 31 December 2017 (2016: £10.8 million). A recoverable of £34.2 million (2016: £11.8 million) has been recognised under the indemnity provided by Lloyds Bank plc (note 30). The size of the liability follows an assessment of emerging themes in customer complaints, an assessment of broader industry commentary and discussions with regulators. The ultimate cost and timing of payments are uncertain as a result of the inherent difficulties in estimating factors such as future levels of customer complaints and remediation settlements. The provision represents management's current best estimate.

32. Notes to the consolidated cash flow statement

The following table presents further analysis of balances in the consolidated cash flow statement:

	2017 £ million	2016 £ million
Change in loans to credit institutions	**99.5**	(299.6)
Change in loans and advances to customers	**(1,478.0)**	(3,097.8)
Change in derivative assets	**32.7**	(157.0)
Change in other operating assets	**(132.0)**	(366.2)
Change in operating assets	**(1,477.8)**	(3,920.6)
Change in deposits from credit institutions	**16.4**	72.6
Change in customer deposits	**1,104.9**	3,545.9
Change in derivative liabilities	**(22.7)**	343.4
Change in other operating liabilities	**76.8**	28.3
Change in operating liabilities	**1,175.4**	3,990.2
Depreciation and amortisation	**27.8**	23.1
Allowance for loan losses	**77.8**	87.3
Other non-cash items	**8.4**	(34.2)
Non-cash and other items	**114.0**	76.2
Analysis of cash and cash equivalents as shown in the balance sheet		
Cash	**143.0**	174.2
Balances with central banks	**7,419.9**	3,473.1
On demand deposits	**0.9**	0.4
Total cash and cash equivalents	**7,563.8**	3,647.7

(1) Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance TSB Group's day-to-day operations.

Notes to the consolidated financial statements

Other important disclosures (continued)

32 Notes to the consolidated cash flow statement (continued)

Change in liabilities arising from financing activities

	Borrowings from central banks £ million	Repurchase agreements £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Total non customer funding £ million
At 1 January 2017	**5.0**	**1,409.6**	**2,940.1**	**413.3**	**4,768.0**
Borrowings under the BoE Term Funding Scheme	**5,615.0**	**–**	**–**	**–**	**5,615.0**
Issuance of covered bonds	**–**	**–**	**497.7**	**–**	**497.7**
Repayments securitisation funding	**–**	**–**	**(2,128.5)**	**–**	**(2,128.5)**
Proceeds from repurchase agreements (net)	**–**	**36.8**	**–**	**–**	**36.8**
Non-cash movements	**5.7**	**–**	**9.4**	**(8.0)**	**7.1**
At 31 December 2017	**5,625.7**	**1,446.4**	**1,318.7**	**405.3**	**8,796.1**

33. Future accounting developments

The following pronouncements will impact TSB Group's consolidated financial statements but are not applicable for the year ended 31 December 2017 and have not been applied in preparing these consolidated financial statements.

Pronouncement	Nature of Change	IASB effective date
IFRS 9 *Financial Instruments*	Replaces IAS 39 *Financial Instruments: Recognition and Measurement*. A description of the changes required by IFRS 9 and the impact of adoption of IFRS 9 on TSB's accounting policies and financial statements is set out on pages 79 to 81.	Annual periods beginning on or after 1 January 2018
IFRS 15 *Revenue from Contracts with Customers*	Replaces IAS 18 *Revenue* and other existing revenue recognition interpretations and requires revenue to be recognised when goods or services are transferred to customers and at an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The standard does not apply to financial instruments or lease contracts. The impact of IFRS 15 on TSB Group is set out on page 83.	Annual periods beginning on or after 1 January 2018
IFRS 16 *Leases*	Replaces IAS 17 *Leases* and brings most leases on-balance sheet for lessees under a single model, eliminating the distinction between operating and finance leases. IFRS 16 requires a lessee to recognise a 'right-of-use' asset and a lease liability. Lessor accounting remains largely unchanged. The impact of IFRS 16 on TSB Group is not expected to be material.	Annual periods beginning on or after 1 January 2019

34. Approval of the consolidated financial statements

These consolidated financial statements were approved by the Board of Directors of TSB Banking Group plc on 1 February 2018.

The Company's ultimate parent company and ultimate controlling party is Banco de Sabadell S.A. (incorporated in Spain), which is also the parent undertaking of the largest group of undertakings for which consolidated financial statements are drawn up and of which the Company is a member. Banco de Sabadell S.A. is the parent undertaking of the smallest such group of undertakings for which consolidated financial statements are drawn up and of which the Company is a member. Copies of the consolidated annual report and accounts of Banco Sabadell S.A. are expected to be available in due course from www.grupbancsabadell.com/en/.

Company balance sheet

As at 31 December 2017

Company Number: 08871766

	Note	2017 £ million	2016 £ million
Assets			
Non-current assets:			
Investments in subsidiaries	4	**1,589.4**	1,589.4
Loans to subsidiaries	4	**387.5**	387.2
		1,976.9	1,976.6
Current assets:			
Amounts due from subsidiaries		**0.1**	0.1
Current tax asset		**0.1**	0.1
Total assets		**1,977.1**	1,976.8
Liabilities			
Non-current liabilities:			
Subordinated liabilities	2	**387.5**	387.2
Current liabilities:			
Amounts due to subsidiaries		**12.9**	12.8
Total liabilities		**400.4**	400.0
Equity			
Share capital	3	**5.0**	5.0
Share premium	3	**965.1**	965.1
Merger reserve	3	**616.5**	616.5
Loss for the year		**(0.1)**	(0.1)
Accumulated losses brought forward		**(9.8)**	(9.7)
Shareholder's equity		**1,576.7**	1,576.8
Total equity and liabilities		**1,977.1**	1,976.8

The accompanying notes are an integral part of the financial statements.

No statement of comprehensive income has been shown for the Company, as permitted by section 408 of the Companies Act 2006.

The Company financial statements on pages 107 to 112 were approved by the Board of Directors 1 February 2018 and signed on its behalf by:

Paul Pester
Chief Executive Officer

Ralph Coates
Chief Financial Officer

Company statement of changes in equity

for the year ended 31 December 2017

	Share capital £ million	Share premium £ million	Merger reserve £ million	Accumulated losses £ million	Shareholder's equity £ million
Balance at 1 January 2016	5.0	965.1	616.5	(9.7)	1,576.9
Comprehensive expense					
Total comprehensive expense for the year	–	–	–	(0.1)	(0.1)
Balance at 31 December 2016	5.0	965.1	616.5	(9.8)	1,576.8
Balance at 1 January 2017	**5.0**	**965.1**	**616.5**	**(9.8)**	**1,576.8**
Comprehensive expense					
Total comprehensive expense for the year	**–**	**–**	**–**	**(0.1)**	**(0.1)**
Balance at 31 December 2017	**5.0**	**965.1**	**616.5**	**(9.9)**	**1,576.7**

Company cash flow statement

for the year ended 31 December 2017

	2017 £ million	2016 £ million
Cash flows from operating activities		
Loss before taxation	**(0.1)**	(0.1)
Adjustments for:		
Change in current liabilities	**0.1**	0.1
Change in current assets	**–**	–
Non-cash and other items	**–**	–
Net cash provided by operating activities	**–**	–
Cash flows from investing activities		
Interest received on financial assets	**22.1**	22.1
Net cash provided by investing activities	**22.1**	22.1
Cash flows from financing activities		
Interest paid on subordinated liabilities	**(22.1)**	(22.1)
Net cash used in financing activities	**(22.1)**	(22.1)
Change in cash and cash equivalents	**–**	–
Cash and cash equivalents at 1 January	**–**	–
Cash and cash equivalents at 31 December	**–**	–

The accompanying notes are an integral part of the financial statements.

Notes to the Company financial statements

1. Basis of preparation

The financial statements of TSB Banking Group plc (the Company), a public limited company (limited by shares), are prepared on a going concern basis and in accordance with IFRS as adopted by the EU. IFRS comprises accounting standards prefixed IFRS issued by the IASB and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee. The Company's financial statements are presented in accordance with the Companies Act 2006. The Company is domiciled and incorporated in the UK and registered in England and Wales. The financial statements are prepared on the historical cost basis.

The accounting policies that are applicable to the Company are included in TSB Group accounting policies and the following policy is also applicable. The future accounting developments, set out in note 33 to the consolidated financial statements are not expected to have a material impact on the financial statements of the Company.

Investments in subsidiaries
Investments in subsidiaries are initially recognised at cost and subsequently held at cost less any impairment charge. An impairment charge is recognised when the carrying amount of the investment exceeds its recoverable amount.

2. Subordinated liabilities

	2017 £ million	2016 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.1**	383.8
Accrued interest	**3.4**	3.4
Total subordinated liabilities	**387.5**	387.2

The Company issued, in 2014, £385.0 million of fixed/floating rate reset callable subordinated Tier 2 notes at an issue price of 99.493% of the principal amount. The notes pay interest at a rate of 5.75% per annum, payable semi-annually in arrears until 6 May 2021 at which time the interest rate becomes 3 month LIBOR plus 3.43% per annum payable quarterly in arrears. The Company has the option to redeem these notes on 6 May 2021 and quarterly thereafter, subject to approval of the Prudential Regulatory Authority.

3. Share capital, share premium and merger reserve

Details of the Company's share capital, share premium and merger reserve are set out in note 21 to the consolidated financial statements

4. Related party transactions

The Company enters into transactions with related parties in the normal course of its business. The tables below detail, on an aggregated basis, related party transactions, balances outstanding at the year end and related income.

(i) Key management personnel
The key management personnel of TSB Group and the Company are the same. The relevant disclosures are set out in note 28 to the consolidated financial statements. The Company has no employees.

(ii) Investment in subsidiaries
The Company's only legal subsidiary undertaking is TSB Bank plc, a banking business incorporated and registered in Scotland whose registered office is Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH. The Company holds 100% of the ordinary share capital and voting rights of TSB Bank plc and carried this investment at its cost of £1,589.4 million (2016: £1,589.4 million).

Notes to the Company financial statements

4. Related party transactions (continued)

In addition, TSB Banking Group plc Employee Share Trust is accounted for as a subsidiary of the Company and the registered office of this entity is 26 New Street, St Helier, Jersey, JE 3RA.

The following entities are accounted for as subsidiary companies of TSB Bank plc as it exercises control of each entity under IFRS 10 *Consolidated Financial Statements.* The registered office of each of these entities is 35 Great St Helen's, London, EC3A 6AP*:*

- Duncan Holdings 2015-1 Limited (and its subsidiary Duncan Funding 2015-1 plc);
- Duncan Holdings 2016-1 Limited (and its subsidiary Duncan Funding 2016-1 plc);
- TSB Covered Bonds LLP;
- TSB Covered Bonds (LM) Limited; and
- TSB Covered Bonds (Holdings) Limited.

(iii) Loans to subsidiaries

	2017 £ million	2016 £ million
Loans to subsidiaries	**387.5**	387.2
Total loans to subsidiaries	**387.5**	387.2

On 1 May 2014, the Company subscribed for fixed/floating rate reset callable subordinated Tier 2 notes due May 2026 issued by its principal subsidiary, TSB Bank plc.

(iv) Other related party transactions

At 31 December 2017, amounts due by the Company to subsidiary companies were £12.9 million (2016: £12.8 million). Amounts due from subsidiary companies were £0.1 million (2016: £0.1 million)

Detail of other related party transactions is given in note 28 to the consolidated financial statements.

5. Financial instruments

(i) Measurement basis of financial instruments

The following table analyses the carrying amounts of the Company's financial instruments:

At 31 December 2017	Fair value £ million	Loans and receivables £ million	Held at amortised cost £ million	Total £ million
Financial assets				
Loans to subsidiaries	**–**	**387.5**	**–**	**387.5**
Total financial assets	**–**	**387.5**	**–**	**387.5**
Financial liabilities				
Subordinated liabilities	**–**	**–**	**387.5**	**387.5**
Total financial liabilities	**–**	**–**	**387.5**	**387.5**
At 31 December 2016				
Financial assets				
Loans to subsidiaries	–	387.2	–	387.2
Total financial assets	–	387.2	–	387.2
Financial liabilities				
Subordinated liabilities	–	–	387.2	387.2
Total financial liabilities	–	–	387.2	387.2

Notes to the Company financial statements

5. Financial instruments (continued)

(ii) Fair value of financial assets and liabilities

At 31 December	2017 Carrying value £ million	2017 Fair value £ million	2016 Carrying value £ million	2016 Fair value £ million
Financial assets				
Loans to subsidiaries	**387.5**	**427.3**	387.2	403.4
Financial liabilities				
Subordinated liabilities	**387.5**	**427.3**	387.2	403.4

The valuation techniques for the Company's financial assets and liabilities are set out in notes 5 and 12 to the consolidated financial statements.

(iii) Valuation hierarchy of financial assets and liabilities carried at amortised cost

The table below analyses the fair values of the financial assets and liabilities of the Company which are carried at amortised cost.

At 31 December 2017	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Financial assets					
Loans to subsidiaries	**–**	**427.3**	**–**	**427.3**	**387.5**
Financial liabilities					
Subordinated liabilities	**–**	**427.3**	**–**	**427.3**	**387.5**
At 31 December 2016					
Financial assets					
Loans to subsidiaries	–	403.4	–	403.4	387.2
Financial liabilities					
Subordinated liabilities	–	403.4	–	403.4	387.2

(iv) Credit risk

The Company's credit risk arises solely from amounts due from its wholly owned subsidiary, TSB Bank plc. At 31 December 2017, the Company held no financial assets that were either past due or impaired (2016: nil).

(v) Liquidity risk

The table below analyses the financial liabilities of the Company by relevant contractual maturity grouping on an undiscounted future cash flow basis based on the remaining period at the balance sheet date.

At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Subordinated liabilities	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
Total	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
At 31 December 2016						
Subordinated liabilities	–	–	22.1	462.5	–	484.6
Total	–	–	22.1	462.5	–	484.6

Independent auditors' report to the members of TSB Banking Group plc

Report on the audit of the financial statements

Opinion

In our opinion, TSB Banking Group plc's consolidated financial statements ("the Group") and the Company financial statements (the "financial statements"):

- give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2017 and of the consolidated Group profit and the consolidated Group's and the Company's cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and, as regards the Company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report and Accounts 2017 (the "Annual Report"), which comprise: the consolidated and Company balance sheets as at 31 December 2017; the consolidated statement of comprehensive income for the year then ended; the consolidated and Company statements of changes in equity for the year then ended; the consolidated and Company cash flow statements for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the consolidated Group or the Company.

Other than those disclosed in note 16 to the financial statements, we have provided no non-audit services to the consolidated Group or the Company in the period from 1 January 2017 to 31 December 2017.

Our audit approach

Overview	
Materiality	Overall Group and Company materiality: £13.4 million (2016: £9.1 million), based on 5% of Group adjusted profit before tax.
Audit scope	The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of reporting units and other qualitative factors (including history of misstatement through fraud or error).
Areas of focus	The areas of focus for our audit which involved the greatest allocation of our resources and effort were: • Impairment of retail loans and advances to customers; and • Multiple economic scenarios, expert credit judgements and selection of 'staging' thresholds as they relate to the transitional disclosure of IFRS 9.

Independent auditors' report to the members of TSB Banking Group plc

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

We gained an understanding of the legal and regulatory framework applicable to the Group and the industry in which it operates, and considered the risk of acts by the Group which were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion. We designed audit procedures that focused on the risk of non-compliance of banking law and regulation relevant to the Group's financial statements, for example compliance with the Consumer Credit Act and financial conduct issues. Our tests included inspecting correspondence with regulators, discussions with legal counsel, and testing particular classes of transactions. We did not identify any key audit matters relating to irregularities, including fraud. As in all of our audits, we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	How our audit addressed the key audit matter
Impairment of retail loans and advances to customers	
Impairment of loans and advances to customers is a key audit matter as it is an area where a high level of judgement is applied in determining the necessity for, and then estimating the size of, any impairment. Retail impairment is calculated on a modelled basis for each portfolio of loans. Inputs to the models are primarily based on historical data. Management have adjusted the modelled provisions to take account of risks associated with the high level of affordability of loans in the current interest rate environment and uncertainties around future house prices. We therefore focused our work on testing these model adjustments.	• We identified and tested the design and operating effectiveness of key controls over the impairment models. We determined that these controls were effective and could be relied upon for the purpose of our audit. • We tested the key assumptions, using modelling specialists where appropriate, in the impairment calculation and also agreed them to historical data where appropriate. • We tested the accuracy and completeness of underlying data used in the impairment models. We found no material differences in these tests. • We tested all significant model adjustments, including considering the basis for the adjustment, the logic applied, the source data used and the key assumptions adopted. We found these adjustments to be reasonable and supportable. • We also considered the completeness of model adjustments identified for latent risks given our own assessment of the industry and economic environment. We did not identify any additional material latent risks not considered by management. Based on the evidence we obtained, we determined that the impairment model assumptions, data used within the models and model adjustments were reasonable and the resulting estimate is in accordance with accounting standards.

Independent auditors' report to the members of TSB Banking Group plc

Key audit matter	How our audit addressed the key audit matter
Multiple economic scenarios, expert credit judgements and selection of 'staging' thresholds as they relate to the transitional disclosure of IFRS 9	
IFRS 9 will be implemented by the Group on 1 January 2018. This is a key audit matter for the 31 December 2017 accounts as the impact of this transition is disclosed in the notes to the financial statements, therefore is subject to audit. The IFRS 9 standard includes a new impairment model, where losses are recognised on an expected loss basis. This contrasts to the treatment under IAS 39, where losses are recognised when incurred and there is evidence to support the fact the loan may not be recoverable. Furthermore, expected credit losses are required to be measured on a forward-looking basis, reflecting the Group's view of potential future economic events. We focused our audit work on the areas of the methodology that we identified as most judgemental. There are three areas we focused on: 1. Expert credit judgements made by management by adjusting the core IFRS 9 models; 2. The thresholds selected to determine a significant increase in credit risk ('staging') and hence whether a 12 month or lifetime loss provision is recorded; and 3. Determining appropriate assumptions in applying forward looking multiple economic scenarios in the models.	• We performed testing to confirm that the methodology in the newly developed models complied with the requirements of IFRS 9. • We understood and critically assessed the models used, including performing independent empirical tests on key model components. No exceptions were noted. • To validate management's 'staging' thresholds, we re-performed key aspects of management's testing and also performed independent back testing to confirm that the criteria selected by management were reasonable. No exceptions were noted. • When testing the application of forward looking information, we validated the accuracy and soundness of the model, and compared the forward looking assumptions to publically available benchmarks and PwC consensus views. • We performed substantive testing on significant expert credit judgments made by management and considered the completeness of adjustments to core models to take account of latent risks. We concluded that the assumptions in expert credit judgements were reasonable and did not identify any additional material latent risks not considered by management. • We performed substantive testing on the extraction of key data from underlying systems and data warehouses that is used in the models without exception. • We reconciled the IFRS 9 transitional impact disclosed on pages 79 to 81 of the accounts to source calculations and models without exception. As management continue to implement IFRS 9, we will continue to assess the transitional impact. Based on the evidence obtained we found that the impairment model assumptions, data used within the models and expert credit judgements made by management to be reasonable and therefore concluded that the transitional impact disclosed is reasonable.

Independent auditors' report to the members of TSB Banking Group plc

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Group, the accounting processes and controls, and the industry in which it operates.

TSB Banking Group plc is the consolidation of TSB Group and its subsidiaries, including TSB Bank plc, for which we issue a separate audit report. We scoped the Group and Company as one component.

For each financial statement line item we considered the financial significance and qualitative factors, including the presence of any significant audit risks, to determine our audit scope. Additionally the risk of material misstatement was mitigated through audit procedures including testing of entity level controls and analytical review procedures.

We do not rely on any component auditors or other PwC offices. As TSB still use the Lloyds Banking Group plc IT platforms, we place reliance on the 'ISAE 3402 report on controls placed in operation and tests of operational effectiveness', that is performed by Lloyds' external auditors.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	*Company financial statements*
Overall materiality	£13.4 million (2016: £9.1 million).	£13.4 million (2016: £9.1 million).
How we determined it	For Group we used 5% of profit before tax, adjusted for exceptional items, as these are not considered to be recurring.	1% of total assets, capped to Group overall materiality of £13.4 million
Rationale for benchmark applied	Statutory profits have been adjusted to remove costs in relation to the transition from Lloyds Banking Group. These costs are material for 2017, but do not reflect the underlying business performance management is focusing on and are not expected to recur. Management have separately disclosed these costs on page 22 of the Annual Report. Therefore adjusted profit before tax is considered an appropriate benchmark upon which to base our materiality.	As the Company is not profit orientated on a solo-entity basis, we have used 1% of total assets, but cap this to the lower materiality of the Group

There is no component materiality, however certain balances were audited to a local statutory audit materiality that was less than our overall Group materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.7 million as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which ISAs (UK) require us to report to you when:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Group's and Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and Company's ability to continue as a going concern.

Independent auditors' report to the members of TSB Banking Group plc

Reporting on other information
The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Directors' Report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic report and Directors' report
In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 December 2017 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Group and Company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' Report.

Responsibilities for the financial statements and the audit
Responsibilities of the directors for the financial statements
As explained more fully in the Statement of Directors' responsibilities set out on page 58, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements
Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report
This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Independent auditors' report to the members of TSB Banking Group plc

Other required reporting

Companies Act 2006 exception reporting
Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the Company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment
Following the recommendation of the Audit Committee, we were appointed by the members on 1 January 2014 to audit the financial statements for the year ended 31 December 2014 and subsequent financial periods. The period of total uninterrupted engagement is 4 years, covering the years ended 31 December 2014 to 31 December 2017.

Laura Needham (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
1 February 2018

EDTF Recommendations

The Enhanced Disclosure Task Force (EDTF), formed by the Financial Stability Board to develop principles for enhanced risk disclosures, issued a report in October 2012 setting out 32 recommendations across seven risk areas. These are primarily aimed at large international banks. However, aligned to TSB Group's commitment to transparency, the table below provides an overview of how TSB Group has responded to the recommendations, where relevant to its business model and risk profile.

Type of risk	EDTF Ref	Description	TSB Group's approach
General	1	Risks to which TSB Group is exposed	A summary of TSB Group's principal risks and uncertainties is disclosed on pages 10 to 13.
	2	Definition of risk terminology, principles and appetite	
	3	Top and emerging risks and changes during the reporting period	
	4	Analysis of future regulatory developments affecting the business model and profitability	
Risk governance and management	5	TSB Group's risk management organisation, process and key functions	Described in the Risk management in TSB section on pages 8 and 9 and in the Corporate governance statement on pages 25 to 32.
	6	Risk culture and risk governance and ownership	
	7	Description of the key risks that arise from the business model, risk appetite, and how TSB Group manages such risks.	TSB Group's principal risks and uncertainties that arise from the business model are explained on pages 10 to 13. Further explanation of financial risks is provided in the notes to the consolidated financial statements on pages 90 to 100.
	8	Stress testing and the underlying assumptions	
Capital adequacy	9	Minimum Pillar 3 disclosures requirements	Disclosed in the Sabadell Pillar 3 report*.
	10	Reconciliation of accounting balance sheet to regulatory balance sheet	Disclosed on page 17.
	11	Flow statement of movements in regulatory capital	Disclosed on page 17.
	12	Discussion of targeted level of capital and how this will be established	A description of TSB Group's capital composition and changes is provided on pages 16 to 18.
	13	Analysis of risk-weighted assets and how they relate to business activities	An analysis of risk-weighted assets is disclosed on page 17.
	14	Analysis of capital requirements for each Basel asset class	
	15	Analysis of credit risk for each Basel asset class	Disclosed in the Sabadell Pillar 3 report*.
	16	Flow statements reconciling movements in Risk Weighted Assets for each Risk Weighted Asset type	
	17	Discussion of Basel credit risk model performance	
Liquidity & funding	18	Analysis of TSB Group's liquid asset buffer	Details of the liquidity portfolio and encumbered assets are disclosed in the 'Review of our performance in 2017' section on pages 20 to 21.
	19	Encumbered and unencumbered assets analysed by balance sheet category	
	20	TSB Group assets, liabilities and off balance sheet commitments analysed by remaining contractual maturity	An analysis of the contractual maturity of TSB Group's assets and liabilities is disclosed in note 24 to the consolidated financial statements.
	21	Analysis of TSB Group's sources of funding	TSB Group's sources of funding are set out in notes 1 to 4 of the consolidated financial statements.
Market risk	22	Relationship between market risk measures for trading and non-trading portfolios and the balance sheet	A summary of the sources, measurement and monitoring of market risk, including sources and sensitivity of net interest income to non-trading market risk is disclosed in note 26 to the consolidated financial statements. TSB Group has no trading market risk.
	23	Discussion of significant trading and non-trading market risk factors	
	24	VaR assumptions, limitations and validation	
	25	Description of the primary risk management techniques employed by TSB Group	
Credit risk	26	Analysis of the aggregate credit risk exposures	A table showing the maximum exposure to credit risk is disclosed in note 23 to the consolidated financial statements.
	27	Description of the policies for identifying impaired or non-performing loans including forbearance	TSB Group policy for identifying impaired loans is disclosed on page 73. A summary of forborne loans is set out on page 94.
	28	Reconciliation of the opening and closing balances of non-performing or impaired loans and the allowance for loan losses.	Disclosure of the movement in the allowance for loan losses is disclosed in note 9 to the consolidated financial statements.
	29	Analysis of counterparty credit risk that arises from derivative transactions	TSB Group's derivatives are set out in note 26 to the consolidated financial statements.
	30	Discussion of credit risk mitigation, including collateral held for all sources of risk	Credit risk mitigation and analysis of collateral held is disclosed in note 23 to the consolidated financial statements.
Other risks	31	Description of other risks	A description of principal and emerging risks is disclosed in the 'Risk Management in TSB' section on pages 10 to 13.
	32	Discussion of publicly known risks	

* As at the date of this report, the 2017 Sabadell Pillar 3 report has not been approved and is expected to be available in due course from www.grupbancsabadell.com/en/.

Glossary

Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency and the entire outstanding balance is delinquent.
Asset Quality Ratio (AQR)	The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers, gross of impairment allowance.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in, through CRD IV, from 1 January 2015 onward. This was further enhanced in December 2017 to refine the capital framework and introduce new elements including the output capital floor. These revisions will come into force between 1 January 2022 and 1 January 2027.
Basis point	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates.
Capability and Innovation Fund	A £425 million fund formally approved in September 2017 as part of an alternative remedies package agreed between the European Commission and the UK Government. The package substitutes Royal Bank of Scotland plc's (RBS) commitment to divest its Williams & Glyn assets as required by the 2009 European Commission approval of state aid measures by the UK Government to RBS. The fund is available to certain qualifying entities and is aimed at promoting competition in the market for banking services to small and medium sized enterprises
Capital Requirements Directive (CRD) IV	On 27 June 2013, the European Commission published, through the official journal of the European Union, its legislation for a CRD and Capital Requirements Regulation (CRR), which form the CRD IV package. Amendments were subsequently made to the Regulation published on 30 November 2013. The package implements the Basel III proposals in addition to the inclusion of new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. The rules were implemented from 1 January 2015 onwards, with certain sections yet to be phased in.
Collectively assessed loan impairment provision	A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.
Common Equity Tier 1 (CET1) capital	The highest quality form of regulatory capital under CRD IV that comprises common shares issued and related share premium, retained earnings and other reserves less specified regulatory adjustments.
Common Equity Tier 1 capital ratio	Common Equity Tier 1 capital as a percentage of risk-weighted assets.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.
Coverage ratio	Impairment allowance as a percentage of impaired loans.
Customer deposits	Money deposited by account holders. Such funds are recorded as liabilities of TSB Group.
Encumbrance	The use of assets to secure liabilities, such as by way of a lien or charge.
Exposure at default	Exposure at default (EAD) represents the estimated exposure to a customer in the event of default. In determining EAD amounts, consideration is made of the extent to which undrawn commitments may be drawn down at the point of default and the application of credit risk mitigation (i.e. eligible financial collateral).
Financial Services Compensation Scheme (FSCS)	The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by management expenses levies and, where necessary, compensation levies on authorised firms.

Glossary (continued)

Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to an obligor's financial difficulties.
Impaired loans	Impaired loans are loans where TSB Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
Impairment allowances	Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.
Impairment Individually/collectively assessed	Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.
Impairment losses	An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than its carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate.
Internal Capital Adequacy Assessment Process (ICAAP)	TSB Group's own assessment of the amount and type of capital it considers adequate to cover the level and nature of the risks to which it is or might be exposed.
Internal Liquidity Adequacy Assessment Process (ILAAP)	TSB Group's own assessment of the adequacy of its liquidity and funding resources to cover the level and nature of risks to which it is or might be exposed
Internal Ratings-Based approach (IRB)	A methodology of estimating the credit risk within a portfolio by utilising internal risk parameters to calculate credit risk regulatory capital requirements. There are two approaches to IRB: Foundation IRB and Advanced IRB.
IT Migration Programme	A programme designed to migrate our IT infrastructure from the one provided by LBG under a transitional outsourcing arrangement to one provided by our parent Sabadell.
Leverage ratio	Tier 1 capital divided by the exposure measure. Basel III reforms introduced a leverage ratio framework designed to reinforce risk based capital requirements with a simple, transparent, non-risk based 'backstop' measure.
Liquidity Coverage Ratio (LCR)	Measures the percentage of high quality liquid assets relative to expected net cash outflows over a 30 day period. High quality liquid assets should be unencumbered, liquid in markets during a time of stress and ideally, be central bank eligible.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses divided by customer deposits.
Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loan-to-value ratio (LTV)	The LTV ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.
Loss given default	Loss given default (LGD) represents the estimated proportion of an EAD amount that will be lost in the event of default. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.
Master netting agreement	An agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.

Glossary (continued)

Net interest income	The difference between revenues generated by interest-earning assets and the cost of interest-bearing liabilities.
Net interest margin	Net interest margin is net interest income as a percentage of average interest-earning assets.
Net Promoter Score (NPS)	NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who score 9-10 after subtracting the percentage who score 0-6.
Partner	An employee of TSB Group.
Pillar 3	The third pillar of the Basel III framework aims to encourage market discipline by setting out disclosure requirements for Banks on their capital, risk exposures and risk assessment processes. These disclosures are aimed at improving the information made available to the market.
Probability of default	Probability of default (PD) represents an estimate of the likelihood that a customer will default on their obligation within a 12 month time horizon.
Regulatory expected loss	Expected loss (EL) represents the anticipated loss, in the event of default, on a credit risk exposure modelled under the internal ratings based approach. EL is determined by multiplying the associated PD%, LGD% and EAD together and assumes a 12 month time horizon.
Repurchase agreements	Short-term funding agreements which allow a borrower to sell a financial asset as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.
Risk-weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the PRA.
Securities financing transactions	Securities financing transactions are repurchase and reverse repurchase agreements, buy/sell backs and securities lending. For the lender (seller) of the securities it is usually a way to raise funds to finance the securities positions. For the borrower (buyer) of the securities it is a way to invest short–term funds or to cover short (bond) positions.
Securitisation	Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities.
Standardised approach	The Standardised approach to calculating credit risk capital requirements requires the use of a standard set of risk weights prescribed by the regulator. Use may be made of external credit ratings supplied by external credit assessment institutions to assign risk weights to exposures. Standardised approaches, following prescribed methodologies, also exist for calculating market risk and operational risk capital requirements.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer.
Tier 1 capital	A measure of a bank's financial strength defined by the CRD IV. It captures Common Equity Tier 1 capital plus other Tier 1 securities in issue, subject to deductions.
Tier 1 capital ratio	Tier 1 capital as a percentage of risk-weighted assets.
Tier 2 capital	A component of regulatory capital defined by the CRD IV, mainly comprising qualifying subordinated loan capital and eligible collective impairment allowances.

Abbreviations

AQR	Asset quality ratio
BPS	Basis points
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive IV
EBA	European Banking Authority
EIR	Effective interest rate
FCA	Financial Conduct Authority
HMRC	Her Majesty's Revenue and Customs
IAS	International Accounting Standards
ICAAP	Internal Capital Adequacy Assessment Process
IFRS IC	International Financial Reporting Standards Interpretations Committee
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IPO	Initial public offering
ISAE	International Standard on Assurance Engagements
LBG	Lloyds Banking Group
LCR	Liquidity Coverage Ratio
LTIP	Long Term Incentive Plan
LTV	Loan to value
NPS	Net Promoter Score
PCA	Personal current account
PP	Percentage points
PRA	Prudential Regulatory Authority
SPA	Sustainable Performance Award
TSA	Transitional Services Agreement

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